The Canadian Chartered Accountant

OFFICIAL ORGAN OF

THE DOMINION ASSOCIATION OF CHARTERED ACCOUNTANTS

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AUSTIN H. CARR, Editor,
10 Adelaide Street East, Toronto

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(The opinions expressed in articles in The Canadian Chartered Accountant are the opinions of the writers of the articles and are not necessarily endorsed by the Association.)

THE DOMINION ASSOCIATION OF CHARTERED ACCOUNTANTS

ANNUAL MEETING

The Thirty-ninth Annual Meeting of The Dominion Association of Chartered Accountants will be held in the Hotel Vancouver, Vancouver, on Thursday, 14th August 1941, for the reception of reports, roundtable discussion, election of officers, amendment of by-laws and for such other business as may be brought before the meeting.

The Council will meet all day Tuesday 12th August and on Wednesday morning and at the close of the general session of the annual meeting on Thursday.

The resolution respecting the amendment of the by-laws of the Association is published in the "General Notes" column of this month's issue.

W. G. Rowe,
President.

Vancouver, British Columbia,
19th May 1941.

Editorial Comment

(Contributed)

Concentration of Accounting Work

Statistics compiled for the Securities and Exchange Commission throw interesting light on the distribution of certain types of engagements amongst accounting firms in the United States. Of 335 engagements in connection with the flotation of stock and bond issues of a million dollars or over, between 1st July 1936 and 31st December 1938, the first firm (in a list based on the number of registrants by which the expert was employed) received 16.12 per cent of the total in number and 20.35 per cent in value of securities offered, the next received 15.82 per cent in number and 18.85 per cent in value, while the first four firms together accounted for 57.91 in number and 69.77 in value. From that point on no one firm received more than 4.77 in number and 3.63 in value. The study comprised 70 firms the last 49 of which secured one engagement each aggregating 14.63 of the total number of engagements and 5.98 of the total value of securities issued.

It is not surprising that there should be a marked concentration of this type of work in the hands of relatively few firms. A substantial security offering involves an appeal to potential investors over a wide area and, as might be expected, this often results in the presentation of accounts certified by a firm of accountants with a wide reputation—one whose name is well known from one end of the country to another. Nor is this any reflection on the skill or efficiency of the less-known firms of accountants who may perform the recurrent audit work for the companies but whose reputation, though quite as high in the particular locality as that of any other firm in the country, has not spread so far.

No corresponding statistics have been published, so far as we are aware, for this country, but a sample analysis which we ourselves have made in respect of the re-financing issues of stocks and bonds through the years 1926 to 1929 suggests an even greater concentration here than in the United States. Of 79 "prospectus" engagements in this period a single firm secured 20.3 per cent in number and 56.1 per cent in amount, the next secured 13.8 per cent in

number and 10.4 per cent in amount. These two firms together were therefore associated with almost exactly the same proportion in value of the Canadian issues as the four leading American firms with issues in the United States. Thereafter in Canada there was a noticeable "flattening out" with no one firm having more than 5.2 per cent in value of the issues and ending with 15 firms "one engagement each" sharing 6.5 per cent in value of the total issues.

The Securities and Exchange Commission commented on the table containing the figures discussed above that it "may be irregular in amount and incidence both in time and as to accountants involved." It therefore prepared another table which might give "some indication of regularly recurring audit work." This second table analyzed 1,998 statements filed for the year 1937 under the Securities Exchange Act of 1934. It showed that two firms of accountants together certified 22.12 per cent of these statements (11.91 and 10.21 respectively), another five firms together certified 30.83 per cent of the statements (the shares ranging from 8.11 to 3.35) and that thereafter the remaining 940 statements were distributed amongst 400 firms. No figures for Canada are available for comparison with these United States figures, but it is reasonable to suppose that a similar situation exists in this country and that recurrent audit work of public companies is more widely and more evenly distributed than is the specialized "prospectus" work.

Corporation Dividend Policy

In the current issue of *The Commerce Journal* Professor C. A. Ashley has an article in which he collects and examines the recorded opinions, on dividend policy, of the authors of standard texts on business finance, of business men and of economists.* The result is a convincing demonstration that management commonly acts in this matter by rule of thumb and that much of the so-called theorizing is merely an attempt to justify what is customarily done.

Statistics quoted indicate that in times of prosperity dividend payments fall much short of earnings, and surplus is accumulated. The often-professed purpose of re-

**The Commerce Journal*, (University of Toronto Press), Vol. I (New Series), Number 1, p. 3.

taining earnings is to equalize dividends throughout the business cycle. But there is a close connection between stabilized dividends and availability of cash with which to pay dividends, and the professed purpose of surplus accumulation can only be served if the accumulating surplus is held either in complete idleness as cash or in relative idleness as gilt-edged securities. If it is to be held in either of these forms it might better be so held by the individual shareholder than by the company, for the shareholder presumably holds his shares as a stake in an industrial or commercial enterprise and not as a banking depositary or investment agency at two removes. In fact however the cash reflecting the accumulating surplus is frequently used by management for purposes of fixed asset expansion—a use which *may* net the shareholder a larger income return than he could secure from any alternative employment, but which means that cash will not be available for the payment of dividends when current earnings drop and when dividends can be maintained only by drawing upon past earnings.

So runs the analysis of the reason most often advanced in support of the retention of profits. There follow critical examinations of other reasons sometimes given for an accumulation policy, namely, "to withstand depressions, to maintain the credit of the company, to enable a gradual growth to take place, (less frequently) to maintain wages in bad times." The author concludes by urging that there is sufficient evidence to justify the substitution of a thorough statistical study for the uncritical belief that the retention of profits and the creation of reserves are always praiseworthy.

Specialization in Accounting Offices

Quite early in the last war the structure of the tax system in Great Britain had become so complicated, and the measurement of income for purposes of income tax and excess profits duty so intricate, that most firms of accountants found it necessary to organize a taxation staff whose members would specialize on the preparation of tax returns for client companies and individuals to the exclusion of all other forms of professional work. By comparison with the British income tax the Canadian income taxes up to the outbreak of the present

war were light and the rules of assessment could be and were simple and indeed almost crude. Now, however, with the greatly increased weight of income taxation and particularly with the introduction of an excess profits tax, refinements are inevitably being introduced both by statute and by administrative ruling, which make the process of measurement of taxable income a task of such complexity and intricacy that it can be performed effectively only by one whose whole time and thought are devoted to this type of work. It is to be expected that here as in Great Britain the demand for men who have so specialized will grow steadily as the war progresses and the incidence of income taxation becomes more burdensome.

Wage Control

The Industrial Relations Section of the School of Commerce and Administration at Queen's University has recently published a short bulletin on "The War-time Wage Policy of the Dominion Government[1]" which assembles in convenient form the relevant orders in council, attempts an interpretation of P.C. 7440 and makes an estimate of the probable effectiveness of the government plan.

As our readers will recall, the provisions of the *Industrial Disputes Act* have been extended to any dispute between employers and employed engaged on war contracts so that there cannot lawfully be any stoppage of work in a war industry until the dispute has been referred to and reported on by a board of investigation and conciliation. This board must conform with the principles enunciated by P.C. 7440; it may not reduce basic wage rates in effect on 16th December 1940, and (inferentially) it may not recommend an increase in these rates unless it can be established that they are depressed and subnormal, but it can award a cost-of-living bonus if certain specified conditions are satisfied.

The bulletin draws attention to three aspects of the plan which present awkward administrative problems. The first of these is the questionable assumption that employers will be able to raise wages as the cost of living advances, the second is the circumstance that even in industries coming within the scope of the Act there is apparently nothing to prevent employers and employees making agreements with-

[1]Bulletin No. 5. April 1941, p. 16. 50 cents.

out resort to a board (and therefore without regard to the principles governing a board), and the third is the exclusion from the plan of industries not engaged on war work. On the second point the bulletin remarks "Consequently, even in the area in which the order in council is designed to control, the confused march of wages may proceed past and around the judgments of the Minister of Labour" and on the third point "if workers are free to offer their services to the highest bidder they may leave the war industries and sell their services to the 'non-essential' industries and it may be necessary to allow further increases in wages in certain of or indeed all of the war industries in order to retain or attract the required number of workers."

Our own feeling in the matter is that the government will be forced by the logic of events to recognize that effective regulation of wages in war industries involves some control over the whole supply of labour. This will certainly mean a temporary and partial restraint upon the individual rights of the worker (as is already the case in Great Britain) but we have no doubt about the willingness of the rank and file of labour to submit to this restraint as the price of escape from the mediaeval serfdom to which a Nazi victory would reduce them.

Labour in Nazi Germany

The implications of a Nazi victory and the consequent and (as it seems to us) the inevitable extension to this continent of the totalitarian concepts and methods of control are difficult to grasp. People in the democracies can conceive of and do even talk about the organization of their labour resources in such a way that everyone will be engaged for the duration of the struggle upon the job in which he or she can make the most effective contribution to the needs of the state at war. Most people, however, are still incapable of grasping the full significance of a philosophy which proclaims as a universal proposition that "it is bad for man to be his own master; that his masters are God-appointed, superior people that compulsion not liberty is the integrating force of society . . . that freedom is an evil."

We spoke above of "mediaeval serfdom" as the lot of the worker in the Nazi regime but according to Dr. Ludwig Hamburger this is an understatement, for the worker in

Germany has been reduced "to a subservience more complete than that which existed under the feudal system of the Middle Ages" and "the position of the German worker out-feudalizes the Middle Ages."[1] By a stream of decrees begun in 1933 and completed shortly before the outbreak of war, the Nazis have fastened upon every German regardless of age or sex a chain which binds him for life to an employer from time to time designated by the state, at a wage set by the state in a place appointed by the state. So "total" is the bondage that under a decree of 10th March 1939 (designed to prevent relatives of farmers, especially children, from giving up unpaid jobs in the country for the sake of a career in the cities) it became unlawful even for any member of the family working in an unpaid capacity to be released from that work except by permission of the employment authorities." What the Nazi government managed to set up, beside and in addition to a system of employment exchange, was a system of compulsory change of occupation and even of the place of work. The method involved, namely, the shifting of people from one occupation to another and even from one place of work to another, belongs to the history of unfree labour. What is original to the Nazi method is the scale on which it has been applied."

[1]Quotations are from L. Hamburger, *How Nazi Germany has Mobilized Labor.* (The Brookings Institution. Pamphlet No. 24, 1940).

SOME FEATURES OF PROVINCIAL GOVERNMENT ACCOUNTING AND FINANCIAL CONTROL

By John Harvey, Chartered Accountant
Victoria, British Columbia

THE attention of accountants has been drawn recently to various features of public finance by the issue of the report of the Royal Commission on Dominion-Provincial Relations, which includes a considerable body of comparative financial statistics on this subject. These figures were compiled with the co-operation of the comptrollers' and auditors' departments of the various governments throughout the Dominion, and are summarized in condensed form in volume three of the report. Additional extensive supporting details are also given in the appendices relative to public finance statistics which accompany the report.

It is impossible to give any comprehensive outline of the classification of government accounts in a short memorandum or to discuss adequately the form in which the annual financial statements are presented for public information. This article is therefore limited to a somewhat sketchy explanation of the methods of accounting for collection of revenue and for controlling the disbursement of provincial funds. The basic procedure in this regard is similar throughout the various provinces and the following notes may be of interest to readers unacquainted with this particular form of public accounts.

Purpose of Government Accounting—The primary purpose of the comptroller's or auditor's department under a provincial authority is to keep full and adequate records of all public moneys received and expenditures made in accordance with the statutes of the province and the authorizations granted thereunder.

The sources of receipts are taxes, licences, permits, fees, liquor control, public domain and other sundry revenue, temporary borrowings for current or relief account, capital borrowings on authority of specific statutes, and trust funds of various kinds, including court deposits, official guardian and estate moneys, and other funds established by statutory provisions from time to time.

Disbursements consist of current account, capital account and unemployment relief account items, and pay-

ments in respect of the various trusts and other funds maintained under statutory authority.

Current account items include the annual charges and expenditures for debt interest, provision for debt retirement, public welfare, education, public domain, highways and public works operation and maintenance, general government and other expenses included in the appropriations listed in the supply votes for the fiscal year, or otherwise authorized by statute.

Capital account items are limited to the purposes named in the loan acts under the provisions of which the respective capital funds are borrowed, and unemployment relief disbursements are classified into direct relief, works relief, or other special relief units.

Administration—The form and extent of the administrative staff in charge of financial accounting varies with the needs of the territory over which the provincial authority extends, and the degree also to which the area is supplied with the services and facilities of municipal bodies organized to administer to local needs. In some provinces the situation is adequately met by centralization of staffs in the main offices at the seat of government, while in others sub-offices are established at various outside points to assist the work of collection of provincial revenue, payment of accounts, and attention to other local governmental services.

In the Province of British Columbia, due to its extent and the widely scattered nature of its lumbering, mining, fishing, agricultural and other business activities, and the fact that organized municipal areas include only Greater Vancouver and the lower Fraser Valley, part of Vancouver Island, and a few small centres in the interior, the provincial government has to operate over fifty outside agencies and sub-agencies to meet adequately the requirements in this regard. Government agents at these points act as land assessors, tax collectors, mining recorders, relief officers and in general fill a position in the sparsely settled unorganized area of this particular province that is served by municipal officials in other provinces where this agency system is not so necessary.

Control of Revenue—All revenue collections are entered in the various forms of cash receipts records maintained by departmental cashiers and outside offices at which col-

lections are accepted. The cash book entries are classified as far as necessary to show the amount and type of revenue received, and the reference number of the original receipt, licence number, certificate, or other form of acknowledgment issued is also recorded. Deposits are required to be made daily to the credit of the central treasury to the full amount of collections for the previous business day and monthly summaries of collections, by sources, are filed with the accounting officials of the treasury for entry in the general books of account of the province. The cash receipts records are examined periodically by the internal audit staff to ensure that all revenue is fully and correctly reported.

Control of Current Expenditures—The annual departmental expenditures on current account are based on estimates presented to and approved by the legislature prior to the commencement of each fiscal year, but the actual appropriations of funds require the consent of the Department of Finance and that of the department in charge of the particular services in question. This method of control by the finance minister or provincial treasurer is designed to prevent over-expenditure, having regard to the actual state of the revenue and the general financial situation existing during the fiscal year, compared with the estimates on the basis of which the supply votes had previously been compiled and approved.

Pre-audit of all expenditures is maintained by the staff of the comptroller-general or provincial auditor, as the title is variously termed by different provinces, and the certificate of that official is required to the effect that legislative authority exists for the expenditure before any disbursement of public moneys may be made.

To establish and maintain the necessary information and control for this purpose, annual detailed expenditure ledgers are maintained in the comptroller's or auditor's office, in which the approved amounts of the supply votes comprised in the estimates of expenditure for the year are entered. These ledgers are divided into convenient sections, and expenditure items are charged to the respective department and supply vote accounts, as the duly authorized vouchers are presented for certification.

No entries are allowed to be made in the expenditure

ledgers which will have the effect of over-running the total of any supply vote or subsection thereof, unless special written permission therefor is given by the finance minister or provincial treasurer. Special warrants are issued to meet necessitous expenditures which were not foreseen and provided for by the legislature and supplementary estimates are prepared and presented to cover anticipated excess expenditures in case the legislature meets in the latter part of a current fiscal year for which the original voted supply is expected to be insufficient.

Unexpended balances in departmental votes or special warrants lapse at the close of each fiscal year. Over-expenditures are shown separately by votes in the estimated and actual expenditure statement included in the published accounts for the year and are summarized in a special schedule included in the financial estimates presented at the next regular session of the legislature.

Capital Account Expenditures—Expenditures on capital account, for highways, bridges, buildings and other permanent works, are provided for from moneys borrowed on authority of the legislature for these specific purposes and held on deposit separate from current account funds. The amounts to be used for individual projects are authorized by orders-in-council, and record of these authorizations is entered in a separate capital expenditure ledger, in which approved vouchers are entered as they are presented, in a manner similar to that used for recording supply vote items in the current account expenditure ledgers.

Unexpended balances, if any, in the capital account ledger at the end of a fiscal year are carried forward to the next period, but total appropriations and expenditures are not allowed at any time to exceed the actual funds provided under each separate Loan Act borrowing, or to be used other than for the specific purposes outlined in each act.

Unemployment Relief Expenditures — The extent and variety of agreements between Dominion, provincial and municipal authorities connected with unemployment relief grants and disbursements in recent years have necessitated a complete segregation of vouchers and accounts to cover this special type of expenditure. The moneys for relief purposes are provided from authorized loan borrowings or

by advances and appropriations from current account, and separate bank accounts and expenditure ledgers are used to maintain the identity of the unemployment relief funds and to facilitate the preparation of the various financial statements and other accounting data required for the many purposes connected with this form of public assistance.

The unemployment relief expenditure ledgers are divided into the main classifications of direct relief and works relief, with further divisions of these classes into the several sub-headings required to conform to the various separate contributory agreements with the Dominion government entered into at various dates in each fiscal year.

Disbursement vouchers prepared by the unemployment relief branch officials are entered in the ledgers under the appropriate agreement heading. It will be recognized that, in contrast with the procedure which limits current expenditure to the amounts of voted supply, no similar maximum can be set for unemployment relief expenditures, as direct relief needs vary from month to month and works relief and other forms of assistance are related to intergovernmental agreements which are dependent on changing economic conditions.

The entries in the unemployment relief ledger are made in considerable detail, as this record is used as the basis for preparing the special statements and certificates required to support the claims for Dominion contributions relative to these expenditures.

Voucher System—A standard form of disbursement voucher is provided which is used by all departmental offices and outside agencies. Invoices or other data are attached to the original vouchers presented to the comptroller-general or provincial auditor for certification, and the supply vote number, loan act reference, or relief agreement title and date, must be stated in respect of current account, capital account or unemployment relief account disbursements respectively. Signatures of responsible officials, supplemented by the approval of the heads of the relative departments, are also required on the vouchers, and the sub-office or agency cheque number and date of issue must be stated for disbursements made prior to certification, in cases where such procedure is allowed for routine or emergency payments.

Payment cheques are prepared in the office of the comptroller-general or provincial auditor in respect of accepted vouchers and a continuous record of disbursements on current expenditure account, capital account, and unemployment relief account is compiled from the duplicate record of cheques issued. This record is closed monthly, to show totals for the month, and totals for current fiscal year to date, and provides a sub-divided control account with which the detailed expenditure ledgers are agreed in totals monthly.

Transfers of sundry items between expenditure accounts, arising from revised information relative to the votes to be charged, or covering adjustments between general ledger and expenditure ledger accounts, are made by means of debit and credit memos, approved and certified in the same manner as cash disbursement vouchers.

At the actual calendar date set for the close of the fiscal year, it is inevitable that considerable portions of the expenditures chargeable against the authorized appropriations included in the supply votes have not yet been fully reported from the sub-offices and outside agencies and vouchered by the various departments concerned. It is therefore necessary to hold the appropriation ledgers open to charge these items to the correct vote and fiscal year, and experience shows that it requires about eight to ten weeks after the nominal closing date to clear all outstanding accounts.

During this period vouchers for the ensuing fiscal year are also being presented for approval and payment, and expenditure ledgers for the new period are therefore opened and operated separate from the previous year's ledgers not yet closed. Separate control register totals for old and new years are kept durng this period of double records, until the final closing of the completed series, usually three months after the nominal end of the fiscal year. A careful record is kept of previous year vouchers presented after final closing and paid by charge against corresponding votes in the succeeding year, and the separate amounts and informative data are duly reported later to the legislature as required by statute.

Detailed Expenditure Schedules—During the fiscal year, the public accounts clerks on the comptroller-general's or provincial auditor's staff segregate the current account filed

vouchers into the supply vote classifications stated in the annual estimates, and the capital account and unemployment relief account vouchers according to loan acts and relief agreements. Salaries are scheduled in the order given in the estimates and expenses by alphabetical order of suppliers, etc., and at the end of the period the completed schedules for publication in the annual printed accounts represent an exact analysis of the entries for the year in the expenditure ledgers in respect of the departmental votes, capital expenditure units and unemployment relief agreements.

Following the completion of this analysis the actual vouchers are filed away, not in numerical order as entered in the ledgers during the year, but in the order published in the public accounts. This arrangement permits of ready reference should information be required at some future date in respect of any particular unit of expenditure listed in the annual accounts.

General Ledgers and Financial Statements—The general ledgers in which the financial transactions of the government are recorded are kept in convenient sectional form in the office of the comptroller-general or provincial auditor, and include accounts relating to current and capital assets, funded debt, temporary loans and current liabilities, department and agency advances and working funds, revenue and expenditure accounts, trust funds and unemployment relief funds.

Entries are made principally on a cash basis during the year and the necessary bookkeeping adjustments for annual closing of the books are determined and recorded at the end of the period. Revenue totals are generally shown on a cash receipts basis, though this practice is not uniform in all provinces. Expenditure totals include unpaid items relative to the current fiscal year in addition to the amounts paid to the nominal closing date, so that the full departmental outlays may be shown in correct relation to the estimated appropriations for the year.

The financial statements for publication in the annual public accounts include schedules showing the state of the public debt, the estimated and actual revenue and expenditure for the year and a balance sheet in which the assets and liabilities of the government are classified as at the

close of the fiscal year. Comparative statements of actual revenues and expenditures of the provincial government for the past few years are also compiled for reference purposes and balance sheets and schedules relative to the operations during the fiscal year of various boards and undertakings owned or controlled by the province and audited by the comptroller-general or provincial auditor are also certified for inclusion in the public accounts.

Public Accounts—The annual public accounts are compiled from the accounts and records maintained by the comptroller-general or provincial auditor and are submitted to the minister of finance or provincial treasurer, to be presented to the legislature at the next session thereof.

There is a considerable variation as between provincial governments in regard to style and classification of balance sheets, funded debt schedules, condensed and detailed statements of revenue and expenditure, and the financial data relative to other matters included in the published public accounts of the various provinces. It may be remarked however that the completeness of the detailed comparative accounting information produced by the several comptrollers' and auditors' departments on uniform lines and published later as public finance statistics appendices to the Rowell-Sirois report shows that the fundamental purpose of government accounting, namely, that of keeping full and adequate records of all public moneys received and expenditures made therefrom, is apparently being well maintained.

THE FINANCIAL STATEMENTS OF A CORPORATION

By K. LeM. Carter, Chartered Accountant, Toronto

IN these notes it is intended to set down a few points in respect to which conventional financial statements fall short of adequately describing the financial transactions during an accounting period and the condition at the end of the period, and to outline a suggested form of report which overcomes to some extent these shortcomings.

The conventional statements set out revenue transactions alone, and the only means that the reader has of ascertaining capital transactions is by comparing balance sheets at the commencement and end of a financial period, which is an awkward and often unsatisfactory method of obtaining information. Even though the capital transactions may be of vital importance to the shareholders the customary financial statements provide no means of reporting them.

The present form of balance sheets is not designed readily to provide information for the uninitiated nor to make clear their purpose. Possibly the most important figure is the amount of working capital, which is not apparent and can only be obtained by a calculation. Very often it is necessary to rearrange a balance sheet in order to compute the shareholders' interest in the company.

The phraseology and accounting terms are clumsy and many companies have adopted the practice of inserting parenthetical phrases against the captions in order that they may be understood. The term "balance sheet" can only indicate that the total of both sides is the same.

The present order of statements would seem illogical, for surely one should first read of what has occurred during the period and finally examine the resultant financial condition.

The audit report would seem to go too far in one respect and be incomplete in others when it states "The balance sheet sets forth a true and correct view of the state of the company's affairs — in accordance with the books of the company." A true and correct view suggests that a balance sheet is either right or wrong, whereas every public accountant knows that he is required to give an opinion as

to whether or not the financial position is a reasonably approximate representation of a position which cannot be definitely established. It might even be deduced from the foregoing words that, if the auditor satisfied himself that the balance sheet agreed with the books, he had completed his work. In fact, in many ways convention means more than the words used and perhaps it is now time to bring the two together.

There appears to be some thought to the effect that auditors should assume responsibility for the proper reporting of revenue transactions as well as financial condition. This being so, why should they stop at revenue transactions?

While the following report may leave much to be desired, it is hoped that it will stimulate further discussion of a problem that to me seems important.

FINANCIAL REPORT OF A-B COMPANY LIMITED
For Fiscal Year Ended 31st December 1940

To The Shareholders,
A-B Company Limited.

Your directors submit herewith the following financial report for the fiscal year ended 31st December 1940:

Operating Income and Expense

Operating income before deducting undermentioned charges		$85,000
Executive salaries	$10,000	
Directors' fees	2,000	
Legal fees	1,000	
Depreciation	3,000	
Provision for income and excess profits taxes	2,000	
Non-recurring items	2,000	20,000
Net operating income		$65,000

Undistributed Income Statement

Balance, 1st January 1940		$10,000
Add: Net operating income for the year	$65,000	
Dividends received from subsidiary company	3,000	68,000
		78,000
Less: Dividends paid	40,000	
Written off goodwill	13,000	53,000
Balance, 31st December 1940		$25,000

The application of the following transactions
(1) Those described in the statement of operating income and expense

(2) Those described in the undistributed income statement

(3) Issue of 2500 shares of capital stock for $25,000 on 3rd June 1940

(4) Redemption of $25,000 bonds on 31st July 1940

(5) Purchase of fixed assets at a cost of $10,000

to the financial position as at 31st December 1939 results in a financial position on 31st December 1940 as follows:

CAPITAL: (Shareholders' interest in the company)			
Capital stock—Authorized 10,000 shares no par value			
Issued 5,000 shares		$50,000	
Undistributed income		25,000	$75,000
BONDS: 5% due 1st September 1945			
Received from sale of bonds			35,000
Total interest of shareholders and bondholders			$110,000
This total is invested in:			
Land		$10,000	
Unamortized cost of depreciable fixed assets:			
Plant	$20,000		
Buildings	15,000		
	35,000		
Less: Reserves for depreciation	10,000	25,000	
Shares of subsidiary company		35,000	70,000
Working capital:			
Current assets:			
Cash		5,000	
Accounts receivable		25,000	
Inventories		42,000	
Deferred charges		3,000	
		75,000	
Current liabilities:			
Accounts payable	25,000		
Taxes payable	10,000	35,000	40,000
			$110,000

It is noted that during the year the working capital increased $21,000 resulting from:

Operating income before depreciation		$68,000
Dividends received from subsidiary		3,000
Issue of 2500 shares of capital stock		25,000
		96,000
Less: Dividends paid	$40,000	
Redemption of bonds	25,000	
Purchase of fixed assets	10,000	75,000
Increase in working capital		$21,000

ON BEHALF OF THE BOARD

____________________)
) Directors
____________________)

TORONTO, 15th February 1941

AUDITORS' REPORT TO SHAREHOLDERS

The Shareholders of A-B Company Limited

We have made an examination of the books and records of the A-B Company Limited in order to confirm the financial report of the Directors to the Shareholders dated 15th February 1941.

We report that we have received all the information and explanations which we have required and that, in our opinion, the aforementioned report properly describes the transactions during the fiscal period and the financial position as at 31st December 1940.

A. B. C. & COMPANY,
Chartered Accountants.

THE USE OF ACCOUNTS*

By C. A. Ashley, Chartered Accountant, Toronto

THE accountant and the business man are often too busy to sit back and ask themselves the question "What is the use of accounts?" But from time to time such questions must be asked, and the answers that are obtained set people thinking along new lines and changes are eventually made in the technique employed. The technique of every business or profession is the result of evolution, which is merely another way of saying that it is adjusted gradually to new conditions. Sometimes the changes are of major importance, and some idea of the causes of major changes in accounting technique will give an idea of its evolution. The first change to notice is the adaptation of accounting to suit the requirements of the great expansion in trade and commerce of the renaissance period; the second its adaptation to suit the requirements of the industrial or manufacturing revolution; the third its adaptation to govern public utilities; and the fourth its adaptation to mass production. A fifth major change is now necessary to suit the requirements of social control. Certain specialized changes such as those required for government, bankruptcy and executorship are ignored.

Early accounts were concerned chiefly with stewardship

*The substance of an address given at Toronto on 17th April 1941 to the Chartered Accountant Students' Association of Ontario.

of the large estates and households. The feudal barons and the lords of manors exercised control through the accounts kept by their stewards: the accounts were "audited" when the stewards read them aloud to their masters. This was a time of agency accounts. The gradual breakdown of the feudal system was accompanied by and was partly caused by the opening of trade routes and the development of market towns. The increase in trade was facilitated by the granting of credit by traders and by banks. Opportunities of trade were sometimes too large for the capital of one man, particularly if he wished to spread his risks by diversifying his business, and this led to the formation of partnerships and joint ventures (the early activities of the Hudson's Bay Co. can be regarded as a succession of joint ventures). The institutions of credit and partnership required changes in accounting technique,—an evolution from the agency accounts of earlier times.

First Accounting Textbook

The first text on bookkeeping was printed during this period in Venice (1494) by a man who taught in the University of Perugia and later became professor of Mathematics at Rome. It contains a full description of double entry bookkeeping. Some of the journal entries made by merchants at this time make up by their picturesqueness for their lack of conciseness. Here is one dated 1550: "Cash is debtor on this day £987. I, Pierre du Mont have received from my master Nicholas de Reo £987 in ready money to be employed for him by way of business. God give me grace to serve well. Nicholas de Reo is creditor."[1] Another one in 1595: "Ready money is indebted to Capital for my 8,000 guilders, and is for different coins of gold and silver that I have in hand in pursuing the trade of merchandise. God will grant me profit and preserve me from loss. Amen."[2] The religious tinge in these entries brings to mind the fact that the great religious foundations kept excellent accounts and that they were responsible for the training of clerks in offices as well as in holy orders. The author of the text referred to was a monk. An English text book of 1588 deals with depreciation, and gives the following example: "Implements of householde here against

[1]A. C. Littleton, *Accounting Evolution to 1900*, p. 114.

is due to have £10.10 for the decay of the said householde stuffe is borne to profit and loss in Debitor."[3] Further illustrations of the progress that had already been made in auditing is shown by the following quotation from a translation of the earliest text:

> This operation, together with the operations of which we will speak, is called the balancing of the Ledger, and if you want to do this well you shall do it with great diligence and order. That is, first you shall get a helper as you could hardly do it alone. You give him the Journal for greater precaution and you shall keep the Ledger. Then you tell him, beginning with the first entry in the Journal, to call the numbers of the pages of your Ledger where that entry has been made, first in debit then in credit. Accordingly, in turn you shall obey him and shall always find the page in the Ledger that he calls and you shall ask him what kind of an entry it is, that is, for what and for whom, and you shall look at the pages to which he refers to see if you can find that item and that account. If the amount is the same, call it out. If you find it there the same as in the Journal, check it or dot it so that you can readily see it. You ask your helper to make a similar mark or check in the Journal at the same entry. Care must be taken that no entry will be dotted either by you without him, or by him without you, as great mistakes might be made otherwise, for once the entry is dotted it means it is correct.[4]

Advent of Incorporated Company

The commercial revolution pushed the remains of the feudal system into a position of relative insignificance, but the industrial revolution, although its effects were profound, increased the importance of trade. The industrial revolution was made possible because it included a most remarkable revolution in transport. Before this time such manufacture as took place was very largely for the market immediately about the place of manufacture; only costly goods for the use of the wealthy could stand the heavy transport charges, and the movement of these goods was slow and risky. With the changes in transport goods could be moved easily, rapidly and cheaply over long distances, and this made possible the large scale use of important resources which happened to be concentrated in a few places; particularly heavy and bulky resources such as coal, iron and other minerals. Manufacture could now take place on a large scale near to the sources of raw materials and the completed goods could be distributed over very wide areas. The economies of large scale production from convenient

[2]*Ibid.*, p. 115; [3]*Ibid.*, p. 223; [4]*Ibid.*, p. 68.

supplies of raw materials outweighed the costs of transport. The improvement in shipbuilding and the use of steam power made it possible to bring goods from foreign countries to supply the food and new raw materials of manufacture for the rapidly growing industrial population. The larger scale of industry and trade called for greater delegation of management and the need for better control through accounts. This large scale industry and trade also created a demand for capital which could not be supplied by owner managers, and this led eventually to the introduction of limited companies in all lines of business. The granting of limited liability to any company which applied for it and submitted to a few regulations came slowly, particularly in England,[5] and some of the accounting changes which were inherent in the industrial revolution were delayed. These changes were required by the progressive divorce of ownership from management. In place of the sole proprietor, or the partnership in which the partners were in daily contact and were liable for all the debts of the business, a new institution became predominant: an impersonal entity, owned by a large number of investors who had nothing necessarily in common except proprietorship in the company, and managed by a small number of people whose stake in the company might be very small and was absolutely limited. The divorce of ownership and management created the new problem of control of directors by shareholders through accounts; and the granting of limited liability created a new problem of the protection of creditors from the dissipation of the company's capital through the payment of dividends in excess of profits.

With the granting of limited liability and the collection of enormous amounts of capital from an amorphous mass of shareholders, social control through accounts started in attempts to protect investors from unscrupulous promoters. The law has followed unscrupulous promoters ever since, usually one jump behind, adjusting itself in the face of opposition even from honest quarters to the changing technique of the promoters. Accounting has always been used by the law but has sometimes also been used by the promoters to further their ends. The form of balance sheet

[5]B. C. Hunt, *The Development of the Business Corporation in England 1800-1867*, Chapter VI.

in Table A of the English Companies Act of 1862[6] is surprisingly modern in many ways, and not until 1935 did the Dominion Companies Act call for a balance sheet as good.

Some of the accounting changes resulting from the introduction of limited liability were very slow in making their appearance; the most important of these delayed changes was probably the switching of emphasis from the balance sheet to the profit and loss account[7] as investors and creditors began to realize that income trend was of greater importance than the balance sheet value of assets. This realization led to much more frequent changes in the holdings of investors and a consequent growth of stock exchanges, until stock exchange regulations began to influence accounting statements. "As the economic forces which direct the destinies of business become better understood, accounting procedures may be expected to be modified and amplified."[8] In earlier times, when the owners of businesses were directly and constantly concerned with management, annual accounts were not of as great importance as they became when an annual statement was the only means by which the management could conveniently report to shareholders. The emphasis on accounts for a period has created grave difficulties in valuation which have caused considerable divergence between accounting and economic concepts.[9]

Public Utilities

The growing importance of public utilities brought about new changes in accounting. The large capital costs of canals, railways, waterworks, gas works, and, eventually, for electric, street car and telephone companies, and the obvious wastes of competition in them, made the granting of monopolies essential. Equally essential was some control of rates, and the arguments on franchise terms were concerned largely with a fair rate of return on capital, which involved allowances for depreciation as a major factor. In Canada the tariff board and various Royal Commissions have faced similar problems to those facing public utility commissions.

[6]Littleton, *op. cit.*, p. 294.

[7]See G. O. May, *Twenty-five Years of Accounting Responsibility*, Vol. 1, p. 72; and S. Gilman, *Accounting Concepts of Profit*, Chap. 3.

[8]C. W. Collins, *Accounting in the Public Interest* (The Canadian Chartered Accountant, November 1939, p. 328).

[9]See R. G. H. Smails, *Economic and Accounting Concepts* (Canadian Journal of Economics and Political Science, August 1937).

Cost Accounting

The introduction of mass production brought with it a major change, in the form of cost accounting. The early methods of cost accounting unfortunately led many people to suppose that this technique enabled them to determine accurately the costs on which selling price could be based, and strange decisions were made as a result of the distribution of costs over joint products. The chief uses of cost accounting have, of course, been to provide a means of control by the management of companies, and to aid the management in determining what proportion of the available physical capacity to use at the prices likely to prevail. The importance of overhead costs or, looked at in another light, the unimportance of overhead costs, has become apparent.

Changing Conditions and Effects

The time is ripe for a further major change in accounting technique which requires a reconsideration of the conventions used by accountants. The operations of every large company have now become a social question; the time of complete freedom of enterprise has gone. (Freedom of enterprise and limited liability are obviously mutually contradictory.) The setting of tariff rates, in a country such as Canada, has repercussions on the whole economy and on political institutions; the importance of taxation as an instrument of social justice has increased; the dependence of wage earners and of whole towns on one company has thrown new responsibilities onto governments; the trade cycle has so terrifying an effect on social welfare that every possible step must be taken to understand and counter it. The accounts of limited companies are no longer merely a domestic matter for the shareholders but are of wide public interest. It is no longer reasonable that private limited companies of vast economic importance should be allowed to operate without publishing accounts. England has been slow to introduce close regulation of accounts, largely owing to the protection to the public inherent in the free trade policy only recently abandoned. The United States has been slow to introduce compulsory audits of limited companies, but the fear of trusts built up behind tariff walls has led to considerable public interest in company accounts. Canada has some of the advantages of

both England and the United States and is in a favourable position for advancing.

The Published Accounts of Corporations

Three chief criticisms can be made of the published accounts of limited companies: first that they do not give sufficient information; secondly that they are inaccurate; and thirdly that they are partly meaningless. Economic research and business judgment require that much more frequent and detailed information should be given by all businesses on such things as stocks of goods, sales, numbers employed and wages paid. The old argument that such information would be of great value to competitors is no longer valid and would, if true, be of minor importance. "Generally speaking, however, important competitors have other sources from which they can obtain more information about a business than is shown in the accounts."[10] The charge of inaccuracy is unfortunately too true to require elaboration; it is partly the result of the judgment in *Newton* v. *Birmingham Small Arms Co. Ltd.*,[11] a long tradition with English writers, that understatements of values were always permissible and usually praiseworthy; and the old emphasis, already referred to, placed on the balance sheet. ". . . it seems reasonable to ask those concerns on whom we confer limited liability to publish accounts which show to the best of the knowledge and belief of the directors the true position and not deliberately to mislead us."[12] Financial institutions, industrial and commercial companies, all publish accounts knowing them to be incorrect and often with the deliberate intention to deceive, frequently from the most honest motives. How is it possible for anyone to attempt to make a satisfactory study of the trade cycle when the basic data are incomplete and unreliable?

One of the chief concerns of accounting technique has been to determine what amount of cash can be withdrawn from a business without reducing its capital; this has also

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[10]Gilbert Garnsey, *Limitations of a Balance Sheet* (Proceedings of the Autumnal Meeting of the Institute of Chartered Accountants in England and Wales, 1928, p. 48).

[11]C. A. Ashley, *An Introduction to Auditing for Canadians*, p. 154.

[12]R. S. Edwards, *Some Academic Doubts about Secret Reserves* (The Canadian Chartered Accountant, December 1936, p. 486); see also the note *Auditors, Shareholders and Balance Sheets* (p. 487 of the same issue).

been a concern of company law. This requires a definition of capital or of income. The companies acts do not define them and the accountant's definitions appear to some people to be meaningless.

> A diligent search of the literature of accounting discloses an astonishing lack of discussion of the nature of income. One could hardly expect that the profession which, above all others, is most constantly engaged in the statistical treatment of income should have found almost nothing at all to say about the nature of the thing they measure so carefully. Nor could one have expected that the academic writers on accounting, many of whom are economists and statisticians as well as students of accounting, should have paid so little attention to this lack of definition and should, apparently, have made little effort to supply the wanting proposition. But the failure to define is plain; and even those semblances of definition that one finds break down when put to the test; for they do not fit, even approximately, what the accountants do. Just why this state of the writings exists can be a matter of conjecture only. Do accountants suppose the nature of income to be so plain and obvious that a definition of it is not needed, even by beginners and by the public who read their statements? Do they, on the contrary, suppose that no generally serviceable definition is possible? Or have they never considered the difference between the nature of a thing and the measurement of the amount of it? Probably none of these extreme guesses is anywhere near the mark.[13]

The accountant is concerned with money values and not with the physical nature of assets; and these money values are arrived at by the application of certain conventions, without regard to prospective earning power. What is the meaning, the economist asks, of the money value attributed to assets whose prospective earning power is negative? The accountant can show how he arrives at the value, but can he say what it means?

Valuation of Fixed Assets

Two of the conventions used in accounting technique are worthy of particular attention. The first is that used in valuing fixed assets at cost less depreciation. The policy of charging depreciation each year on new assets has the effect of increasing the liquid fund available within a business which may result in an automatic expansion of operations; but this corollary is frequently overlooked. The conventional methods of charging depreciation are probably the least consistently applied of all the accounting conventions, and perhaps the commonest of the reservations to be

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[13] J. B. Canning, *The Economics of Accountancy*, p. 93.

found in auditors' reports is in respect of the adequacy of depreciation reserves. The fact that the methods are not always convincing in theory and not carried out in practice calls for a reconsideration of the methods. "It is submitted in conclusion, in view of the subjective quality of any figure of periodical depreciation, that accountants should develop a figure of periodical 'operating income' *before charging depreciation* and that any subsequent deduction for depreciation should be understood to have no precise significance except as the amount of resources made available for reinvestment by the policies of management in the period in question."[14] Some people would carry the implications of this further and would show the acquisition of fixed assets as a final sinking of capital and acknowledge that their ultimate replacement depends on management policy and possibly the raising of new capital. The fact that depreciation reserves are not intended to provide and seldom do provide funds for replacement is not generally understood.[15]

Valuation of Inventories

The second convention of major importance is that used in valuing inventories. Unfortunately every known method of inventory valuation has a great deal to be said against it, and the application of one method is not always consistently followed. The Dominion Companies Act requires a statement of the method, but the statement on many balance sheets agrees with the letter rather than with the spirit of the Act and leaves large margins of doubt, so that such statement is useless to anyone who has not access to other records of the companies.

An old fashioned belief in conservatism in accounting statements is responsible for the survival of the cost or market method of valuation. "Valuation of an inventory at realizable market price when lower than cost was an inheritance from the early trading ventures, strongly encouraged in later years by the doctrine of conservatism preached by credit men and accountants under the influence of the balance sheet viewpoint."[16] This method emphasized

[14]Smails, *op. cit.*, p. 453.

[15]See C. A. Ashley, *Notes on Depreciation* (Commerce Journal, 1940).

[16]Gilman, *op. cit.*, p. 363; see also May, *op. cit.*, Vol. 1, p. 191; and R. G. H. Smails, The Canadian Chartered Accountant, August 1938, p. 161.

the depressive effect of falling prices and may, through the contraction of credit and the psychological effect on business men, contribute to the violence of fluctuations. "It is not intended to belittle the value of conservatism, but its effects on the accounts is not always appreciated."[17] The effects of changes in the value of money are not reflected in balance sheets, but they have far reaching effects on the information which balance sheets are expected to give. "If there has been a rapid and substantial change in the general price level, has not the accountant so hopelessly mixed dollars of so many values in his calculations as seriously to distort the profit and the financial position?"[18] "Business men are currently making vital decisions on the assumption that their books are providing a record of realized or expendable earnings. In so far as their actions are influenced by their failure to understand the fictitious nature of inventory gains, they are likely to make decisions which will lead not only to a dissipation of the resources of their own business, but also an accentuation of the booms and depressions of business as a whole."[19] The "basic stock" method has a great deal to recommend it in certain types of business, and it has the effect of reducing fluctuations in profits. The "first in first out" method is, perhaps, the one which comes nearest to the truth; it tends to accentuate fluctuations in profits, and if you ask what I mean by "nearest to the truth" I cannot give a reply which will satisfy me—let alone you.[20]

The report of profits is a matter of great consequence; on it decisions of grave economic importance are based. ". . . accounting has become more and more independent in its viewpoint until it now commonly is depended upon by legal and administrative authorities for guidance in many decisions affecting economic interests."[21] But what is the profit reported? It is sometimes the result of the inconsistent application of certain conventions to arrive at

[17]Garnsey, *op. cit.*, p. 50.

[18]L. R. Chenault, *Business Concepts and Economic Theory* (American Economic Review, March 1941, p. 99).

[19]H. B. Arthur, *Inventory Profits in the Business Cycle* (American Economic Review, March 1938, p. 36).

[20]See other articles in The Canadian Chartered Accountant by A. R. Davis (February 1938); G. C. Ferrie (March 1940); and J. R. Wilson (January 1941).

[21]DR. Scott, *The Cultural Significance of Accounts*, p. 283.

a figure which is demonstrably inaccurate and which is, in any case, devoid of significance. The late Lord Stamp expressed this more forcibly: "Now why the financial community should acquiesce in a condition of things in which a balance sheet can be almost anything, I cannot imagine."[22] He should have known the reason: it is because conditions have changed so rapidly that accounting technique has not yet adjusted itself to the new requirements. The adjustments will develop gradually as a result of a more widespread understanding of the problem. In the meantime a faithful adherence to the present technique will help this understanding. The form of published accounts can be far more readily standardized than is usually admitted, and there is little reason why the figures appearing in those accounts, whether they mean anything or not, should not at least be accurate within the limits of the existing technique.

"It is easy to lay down as an abstract proposition that you must not pay dividends out of capital, but the application of that very plain proposition may raise questions of the utmost difficulty in their solution."[23] The intention of the latter part of this paper is not to criticize present practice, but to draw attention to some of its limitations, particularly in connection with the use of accounts for social purposes. "From the economist's point of view, and for the good of the public, it is of very great importance that the accountants should make their income statistics as full and as complete as the conditions of their professional practice will permit. The professional accountants as a whole are abundantly able to give us better statistics than they do. It is to be hoped both in their own interests and the interests of the public as well as in the interests of their clients, that they will continue to press upon the notice of their clients the very great importance of better and fuller measures of income."[24] My last quotation, had it come first, might have saved a good deal of time. "But anyone who has the patience to find out for himself what accountants actually do and who will reflect upon what he

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[22]*Current Problems in Finance and Government*, p. 15.

[23]Halsbury, quoted in Plender, *The Accountant's Certificate in Connection with the Accountant's Responsibility*, p. 21.

[24]*Canning, op. cit.*, p. 177.

finds, will discover that modern accounting practice is, on the whole, sounder than that which has been written about it."[25]

VARIABLE BUDGETING AND THE CONTROL OF MANUFACTURING EXPENSES*

By Alan W. Bell, M.B.A., Montreal

(Continued from April issue)

THE purpose of this article is to amplify on certain aspects of variable budgeting as outlined by the writer in the April issue of THE CANADIAN CHARTERED ACCOUNTANT. Actual numerical examples will be used as much as possible, and although all figures and examples are purely fictitious and over simplified they will serve to bring out certain of the technical details in the preparation and use of variable budgets as they apply to manufacturing expenses.

At the outset it must be emphasized that even where a company has had experience with standard costing and perhaps also with fixed or static budgets, it cannot hope to introduce complete variable budgeting in a month's time. It is necessarily a slow process, and the patience and cooperation of all the staff will play a large part in its success or failure. A typical sequence is first the introduction of a fixed budget, second, the adoption of standard costing, thirdly, the use of variable budgets for indirect labour only, and finally, the use of complete variable budgeting. For many firms, the development through these three stages has been a matter of five to eight years. This is not to say that it cannot be done with perfect success in a much shorter time. The experience of companies in the past should be of great help to those faced with the problem today. However, the old adage, "Don't bite off more than

[25] *Ibid.*, p. 25.

*In concluding this series of two articles on Variable Budgeting, the writer wishes to acknowledge his indebtedness to Professor Ross Graham Walker of the Harvard Graduate School of Business Administration who provided a large part of the background and much of the terminology for the articles. The writer also owes much to the late Professor John Gurney Callan of the same School for his inspiration and advice in the preparation of the first article which was submitted in partial fulfilment of the requirements for his course in Factory Management.

you can chew," applies equally as well in accounting as in other things, and accordingly one should be careful not to prejudice the success of the whole venture by expecting to accomplish too much in too short a time.

Before proceeding to present a simple illustrative case, it will perhaps be wise to summarize briefly the chief points brought out in the previous article. Variable budgeting has two principal uses:

(a) Control of costs, first by controlling the methods and equipment used; second, by a careful determination of what costs should be at different volumes of production under the above-controlled conditions; and third, by prompt reporting of all variances from these variable standards, noting their extent, trend and the persons responsible for them. The co-operation and active interest of all employees is to be emphasized.

(b) Provision of data showing the basic cost characteristics of the business, to be used as guide-posts in solving many management problems. This is gradually being recognized as its most important function.

Control of Costs—Looking first at the control of costs, it is to be noted that the first prerequisite is controlled methods and equipment. Standards must not perpetuate present inefficiencies. This is vital, but as it involves so many non-accounting problems no further mention will be made of it. The next step is to determine what costs should be, and here reference will be made to manufacturing expenses only. To exemplify, department A is a machine department of a concern manufacturing farm equipment. For some time the company had been using a standard costing system. Control was achieved principally by analysis of variances of actual from standard costs by breaking such variances into a volume factor and an efficiency factor. Much had been achieved, but the production manager still felt that the system had serious weaknesses. A number of such weaknesses were discussed in the first article in this series.

After considerable thought it was decided that some sort of control through variable standards was needed. The management realized that no matter how well a system might appear on paper it would fail miserably unless those charged with its operation were fully capable of the job.

The comptroller could recall a number of cases where professional accountants and engineers had failed to give adequate attention to this important problem. Since the men in the machine shop were more highly trained and educated than those in most of the other departments, it was thought that the initial experiment should be carried out in that department. The fact that all the senior men in the department had had experience with standard cost procedures was also considered important in making this decision.

Departmentalization and Selection of a Measuring Stick of Productive Capacity—The department was a unit in that there was one supervisor in complete charge of all expenditures. All operations were carried on in one building, and it was not so large as to make it impossible for the supervisor to give attention to detailed control over costs. He was to be made responsible for all costs in that department over which he had control. Allocated service costs were thus excluded from his budget.

After considering all the arguments for and against, and after the production manager had inquired into the practices of a number of companies which had pioneered in the field of variable budgeting, machine hours was chosen as the best measure of output in the department. The reasons for this choice were briefly as follows:

(a) Machine operations predominated in the department.

(b) Rigid control had been achieved over machining operations, so very little distortion could be expected as a result of using an uncontrolled base to measure what overhead should be.

(c) Although there were many types of machines in the department, each with different operating costs, an examination showed that the mix of products going through the department remained practically uniform from period to period. The management was aware of the statistical limitations of the base selected, and realized that any substantial change in the mix would destroy the validity of the new standards. Two possible refinements were open to the company to overcome this weakness. The department could have been broken down into a number of smaller parts each with its own measuring stick of output. Like

machines would be grouped together for accounting purposes. Or, alternatively, a weighted machine hour could be used as a yard-stick against which to measure the expenses of the whole department. For instance, machines might be divided into two groups, heavy and light, and an investigation might show that as far as expense variations were concerned, two heavy-machine hours would be the equivalent of three light-machine hours. Then 100 heavy-machine hours and 300 light-machine hours would be the equivalent of 300 heavy-machine hours for the whole department. However, at least in the beginning, a straight unweighted machine hour was to be used. Some accuracy could be sacrificed for simplicity's sake, and in addition, there would be a saving in the cost of operating the system as compared with a more complicated one.

(d) The fact that the mix of products varied only slightly, also made it possible to convert the machine hour base into a dollar cost base common to all departments. That is, total dollar cost would be practically a constant function of machine hours operated. In other words, it might be that the total cost of the output of the department was equal to five times the machine hours. If the total output were forecasted as 8,000 machine hours, the total costs would be $40,000. If this were done for all departments, it would be quite easy to draw up an accurate schedule of total net profit, gross operating profit, and margin between sales and variable costs at all volumes of production. In graphic form this is known as a profitgraph, and in this form it shows up the relation between cost, volume and profits very clearly.

(e) The measure was simple and easy to work with, and the men in the department had become accustomed to refer to the output of the department in terms of machine hours.

Study of Cost Behaviour—The production load in this mythical department usually hovered between 1,000 and 3,000 machine hours per week, and it was therefore thought desirable to study costs carefully at both these volumes and

Exhibit 1

Indirect Expenses Department A at Different Machine Hour Loads

Description of Item 1	1,000 Machine Hours 2	2,000 Machine Hours 3	30,000 Machine Hours 4	Theoretical Fixed at Zero Load 5	Variable Portion per Machine Hour 6	Computed Budget at 2,700 Machine Hours 7
Labour						
Superintendent	$ 75	$ 75	$ 75	$ 75	$	$ 75

Asst. superintendent	50	50	50	50		50
Foremen	250	250	(a)275	250		(b)250
Charge hands	80	140	200	20	.06	182
Inspectors	100	200	300		.10	270
Plant and cost clerks	190	200	(a)220	190		(b)200
Production chasers	40	80	120		.04	108
Tool maker	90	180	270		.09	243
Storekeeper and helpers	65	130	195		.065	175.50
Material						
Grinding wheels ..	10	20	30		.01	27
Lubricants and waste	8	12	16	4	.004	14.80
Other operating supplies	120	220	320	20	.10	290
Maintenance material	90	140	190	40	.05	175
Total controllable expense	$1,168	$1,697	$2,261	$649	$.519	$2,060.30

(a) Although these two cost items apparently have a variable element in them which appears when moving from the 2,000 hour level, they belong to the general class of expenses which do not vary at all proportionately with changes in volume. There would be little logic in classifying any part of this expense as variable in the sense in which it is used here.

(b) Although the above table does not show at what point the increase in these expenses takes place, the more detailed schedule of indirect labour costs shows that they should be $250 for foremen and $200 for clerks at the 2,700 hour load.

also at the intermediate 2,000 machine hour level. Past experience was not taken as the governing factor in determining what costs should be at these levels. Actual studies were made of operating conditions and methods. The department supervisor was instructed to prepare the figures shown in Exhibit 1 (excluding column 7), and these budget figures were then reviewed with the works manager who adjusted the original estimates in some cases. The department supervisor did however accept the adjusted figures as indicative of the performance that could be expected of him. Actually, the indirect labour was budgeted at eight load levels, and the budget report showed details as to the number of each class of worker involved and the number of hours worked. This extra detail is omitted from the exhibit as shown here. The figures shown in columns (2), (3) and (4) have been arranged so as to give a perfect linear correlation between the expenses and machine hours. In practice the actual computed estimates of what costs should be at these levels would be adjusted up or down so as to

give this result. Of course if the examination of the expenses clearly shows that a certain expense does not vary proportionately with changes in volume, then the whole theory of straight line variable budgeting falls to the floor as regards that expense. In such a case it would be given separate treatment along with certain of the less variable indirect labour expenses.

Discussion of Exhibit 1—In the first place, it is to be emphasized that the department supervisor was solely responsible for all the cost items in the budget. No prorated charges were included. Columns (2), (3) and (4) need no explanation. The theoretical fixed costs at zero load can be found graphically or algebraically. Using the latter, one finds that in the case of charge hands an increase in load of 1,000 machine hours causes an increase in the expense of \$60. That is, the variable portion of the expense is equal to \$0.06 per machine hour, which gives a variable cost at the 1,000 machine hour level of \$60. The fixed element, therefore, is \$80 less \$60 or \$20. So with each of the other expenses, and with the total for the department. It must not be inferred that the actual expenses at a zero load would correspond with the figures in column (5). When operations are at a very low level, most of the indirect costs vary more in relation to management policy than to output. This is especially true of indirect labour costs.

Using the Budget in Cost Control—Assume that the department has been operating at a load of 3,000 machine hours for some time, and that the supervisor has received instructions to prepare for a load of 2,700 hours. He is told that he can expect to maintain output at this level indefinitely.

The first point to notice here is that the supervisor is given warning of the coming slack in activity, and is thus given an opportunity to organize his department to meet the new conditions. The more accurate the forecasts of activity are, the better will be the cost control. The next point is that the new and lower level of output is expected to last for some time. The action to be taken may be quite different here than if only a temporary lull were expected. In the latter case some variation from the budget might actually be planned for, either because it would be

impractical to alter the remuneration of all the indirect workers for a short time only, or because of possible ill effects on the morale of the men as the result of a too mechanistic adherence to the budget. In this case, the variance would reflect the cost of the management decision involved.[1]

On receiving his instructions, the supervisor will prepare his new budget as is shown in column (7) of Exhibit 1. He must then plan to meet the new operating conditions. Some expenses such as lubricants should adjust themselves quite automatically, while others such as maintenance material and general supplies will need much more careful watching. Indirect labour costs may be adjusted by changes in salary, changes in number of hours worked or possibly by transfers to other departments. The budget figures assume a flexibility of indirect labour costs which may not be very realistic under certain conditions. The general business and labour situation is always an important factor when deciding how freely you will lay off men, especially foremen. Nevertheless, as has already been pointed out, variances will then show the cost to the company of pursuing for example a policy of stabilizing employment, and on the other hand, it gives the company reliable cost information to support a policy of letting men go or reducing hours or rates of pay in times of falling production.

Constant analysis and follow up of all variances are, of course, the next step. Minor variances are of little importance unless they persist and bulk large on a cumulative basis. It has already been pointed out that volume is but one of a number of factors affecting costs, and that the more acquainted the management is of the relative importance of these other factors, the better will it be able to interpret budget variances intelligently.

Control of Service Department Expenses—There is no need to go into detail here. The principle is the same as with producing departments, and although it is sometimes much more difficult to find a satisfactory measure of productive activity, once found, control can be quite effective.

[1]There is some debate as to whether it is better policy to work out the budget on the assumption of a long period of operations at the new level, and explain and interpret the variance in the manner suggested above, or whether it is wiser to amend the budget to show what costs should be under the assumed conditions.

In general, however, it may be said that control of service department expenses, along with the control of distribution costs, still provides a most fertile field for accounting pioneering.

Need for Constant Revision of Standards—Obviously, the success of the whole control system depends on the validity of the variable standards. A change in any of the statistical components of the standards will require a change in the standards themselves. Changes in the prices of materials or in the rates of pay of indirect workers are the most apparent of such changes. In the example given, a change in the mix of products would distort the budget standards. Finally, changes in methods of operation and adjustments due to gradual improvement in cost control will also necessitate changes in the allowances. Most companies have found it desirable not to make changes more often than is absolutely necessary, say two times a year except in cases where there has been a major change in conditions.

Examples of the Use of Variable Cost Statistics

(a) **Relation between Cost, Price, Volume and Profit**—To find the proper balance between cost, price, and volume is one of the most fundamental of business problems, and one which is of especial interest to the student because it provides such a clear link between discussions of business and of pure economics. This is well illustrated in a recent study made under the auspices of the General Motors Corporation[2] in which all the factors affecting the demand for automobiles was carefully analyzed and an appraisal made of the probable effect on sales of changes in price. The supply side of the equation was also investigated, and this involved estimates of costs at various assumed volumes of output. And with these statistics on the factors affecting demand and supply, sound conclusions were possible on the question as to how far it would be feasible to attempt to offset a fall in volume of sales by lowering prices. The United States Steel Corporation made a somewhat similar investigation[3] in connection with hearings on the steel industry before the Temporary National Economic Commit-

[2]*The Dynamics of Automobile Demand*, General Motors Corporation, 1939.

[3]*An Analysis of Steel Prices, Volume and Costs*, United Steel Corporation, 1939.

tee. In all such studies the reliability of the cost data is important in appraising the conclusions reached, and if this reliability has been tested by the actual operation of a variable budgeting system, executives can place just that much more confidence in them.

Every manufacturer faces many problems when determining what pricing policy he should follow. He poses such questions as these to himself: How important is the price factor in the marketing of my products? Assuming an increase in sales of x% consequent on a given price decrease, what change can be expected in *total* costs? In net profits? Will this last, or will it merely result in a disastrous price war in the industry? Would the company be further ahead in the long run if it tried to increase sales at present prices by improving the product or by increasing selling effort? In all these cases a knowledge of the differential costs of the company is very important.

No claim is made here that it is part of the accountant's job to set selling prices. Clearly it is not. However, it is an essential part of his work to present the general management council with accurate and well organized reports of cost information which bear on such problems as pricing. Cost calculations, though necessary, are but a part foundation on which the final decision must be based. A striking example of this is given by the experience of a large metropolitan department store in selling its own private brand of face cream. Here it was found that a considerable increase in price, along with a change in name, brought forth an enormous increase in unit sales. This was explained by the fact that the original price was so much lower than that of the nationally-advertised brands of cream, that customers apparently got the impression that it was at best a second-rate product. A narrowing of the price spread quickly dispelled that impression. This example is given to impress upon the reader the fact that cost information is not the only thing to consider in pricing.

(b) **Acceptance of Large Orders**—Company A manufactures a small tractor for use on average sized farms. It is operating at about 70% of capacity, and at that level the average cost per tractor is $300 made up as is shown in column (1) of Exhibit 2. The company receives an offer from a large firm in Buenos Aires to buy 1,000 such trac-

tors at $280 apiece. Should the order be accepted? Can the company make money by selling below "cost"? Accurate variable cost statistics are available because the company has been using them to control costs, and from them it is ascertained that the total net increment in costs of all kinds arising out of the acceptance of this order would be $260,000, made up as is shown in column 2 of Exhibit 2. The sale will bring in $280,000, giving a net increase in profits of $20,000. Care is needed in entering into transactions such as this, however, and the possible effect of it on the company's regular business must be considered.

Exhibit 2

Item	1 Original Average unit cost	2 Total increase cost for 1000 extra units	3 Per unit cost of increased output
Material	$180	$180,000	$180
Labour	60	60,000	60
Burden	60	20,000	20
Total	$300	$260,000	$260

And just as a company has overhead costs and increment costs, so has a nation. And if one lets his imagination run and thinks of overhead costs on a national scale, he will marvel at the significance which even the above simple example has for Canadian and American export businesses should they face a Europe entirely dominated by the German Reich. Anyone who doubts that Hitler could force us either to adopt a totalitarian state in this country, or face economic collapse, will find little comfort in a thorough examination of the implications of overhead costs to a nation.

(c) **Other Uses**—A number of other uses of variable cost data come to mind, but only brief mention will be made of them. Whether a company should close down its foundry and purchase castings outside often has to be decided when volume falls off greatly. Cost information of the type that has been discussed, along with judgment as to the probable length of the lull, the labour problem, the reliability of outside suppliers and the cost of purchasing, all bear on the problem. Again, a company will often wish to know how much of an increase in sales will be necessary to make an advertising program successful. Or, it might have an important effect on final net profits whether a given order were allocated to plant A operating at 80% capacity, or to plant

B operating at 60% capacity. In all these cases the availability of reliable statistics on the variability of costs makes the proper solution much easier.

Conclusion—In conclusion, it is important to emphasize again that there are a number of different points of view from which costs can be examined. It is pointless to talk of costs except in relation to some specific problem. The cost which is appropriate for the valuation of inventories and the determination of cost of goods sold is not necessarily appropriate—almost certainly will not be appropriate—for judging efficiency in the factory, and may or may not be of significance in considering the pricing problem. In other words, any concept of cost which has an effect on pricing or other management policies is important regardless of its logic from an accounting point of view.

ECONOMIC NOTES

Limitations of the Canadian Budget

Editor's Note: This is the second in a series of notes on economic subjects by Lawrence B. Jack, M.A., Montreal. The first by Mr. Jack was published in last month's issue.

THE budget handed down by Mr. Ilsley on 29th April last got a uniformly good reception in the country. The public had been prepared for heavier taxation when estimates of total expenditure were made public some time earlier, and by now everybody has become reconciled to the fact that no war can be won the easy way. The only question that can be raised is whether or not the budget represented a real attempt at economic mobilization for war purposes or merely an exercise in accounting. Some judgment can be had on this by looking at the policies and objectives as outlined in Ottawa, comparing the results produced with budgets of other belligerent countries, and analyzing the results with reference to the basic principles of war finance.

The budget speech of 24th June 1940 set out our Dominion government's objectives. These were, first, "to bring the country as rapidly as possible to the full use of its resources and manpower." The second was to follow "as far as may be practicable a pay-as-you-go policy." This

was intended to prevent the disorganization inherent in inflationary rises of prices and incomes. The first statement is unobjectionable in that it merely outlines the fundamental necessities of total war; the second, however, is more open to cavil. Does the pay-as-you-go technique most efficiently get at the heart of the inflation problem? Is heavy taxation the best possible means of channeling consumer demand so that the maximum productive potential of the nation will be diverted from consumer's goods to war goods? It is submitted that, while the budget was adequate as a revenue-raiser in view of contemplated expenditures, it was not fully satisfactory as an instrument for assuring the maximum possible production of military supplies. It is further submitted that the best way to achieve this end includes not only the medium of taxation but also a degree of rationing which does not as yet seem to be contemplated in Ottawa.

One indication that Ottawa's latest effort limps along behind the times is provided by a comparison with the last British budget. Mr. Ilsley said, "I have endeavoured to raise the rates of direct taxation to the highest level which I think the Canadian people can be asked to bear in this historic year." Although no two tax systems are directly comparable, it is remarkable that for the bulk of the population British income taxes are so much higher than Canadian. Anyone who does not enjoy an income well over $50,000 a year will remember that when he looked at the ghastly tables provided by the press to see how much more he would have to pay as income tax next year than this he probably noted that the British 50% income tax weighed far more heavily on an Englisman with an equivalent income than Mr. Ilsley's new levies would on him. In Britain it was possible to raise normal rates to this extent and to lower exemptions partly because of adoption by an indirect method of the much-advertised Keynes Plan, which provides for repayment of a portion of direct taxation.

At this point we can go to the basic principles of war finance and see wherein simple increases in taxation, plus exhortations to individuals to increase their savings on a voluntary basis, may well fall somewhat short of ensuring that reduction in individual consumption which must be had if we are to achieve "full use of (Canada's) resources and manpower" for war purposes, yet avoid inflation. Since

increases in taxation must tend to be neutralized, at least partially, by reductions in savings, it is quite certain that ultimately conventional budget procedures will fall short of achieving an all-out war effort; rationing will be necessary as in Britain and Germany. It is naïve, however, to think that cutting down supplies of consumer's goods will create sufficient savings to finance war expenditures. In itself, reduction of supplies only aggravates the problem of inflation, which is the problem of surplus purchasing power in relation to available supplies of consumer goods. It is unlikely that people would use all their surplus incomes to bid up prices, but it is certain that they will not voluntarily cut down their normal spending activities to such an extent as to leave prices wholly unchanged. The only sure solution is to set a limit to individual retail expenditure by issuing ration cards or by setting a ceiling on total consumer spending by some other means. Specifically, what should be done is to divert spending from those articles which use raw materials necessary for war production. In other words, prevent or greatly discourage individuals from buying such things as automobiles, refrigerators, radios, etc., and set a limit to their total purchases of all other types of consumer goods. Once this is done, the detailed methods by which war is financed will not matter because all the productive facilities of the country, over and above a predetermined amount available for consumption goods, will be available for war purposes.

To rephrase the whole argument and put it in its starkest form: if the authorities greatly increase the difficulties of spending money on non-essentials to a point at which the *total* expenditure of the nation is effectively rationed, then it is a secondary consideration whether the government mops up the unspent or unspendable purchasing power or not. If it is taxed away, well and good; if it is deposited in banks it may be mopped up by issue of treasury bills without fear of inflationary consequences. What is important is that no more than a predetermined fraction of productive facilities will be concerned with putting out consumer's goods.

Thus the latest Canadian budget is only a half-way house. It has raised taxes drastically, but taxes are at best a blunt and inaccurate tool for cutting down consumption along the lines that are required. It was pointed out

last month that Canada's *financial* war effort compared favourably with that of several other belligerent nations. The time is coming however—if it is not already at hand—when our fiscal authorities must go behind the façade of money, taxation and borrowing and ration the real things that are at present being consumed and that may be turned to use in the form of war materials. Further than that, the necessity will sooner or later arise for setting an absolute limit to total consumption of all kinds. In other words, there must ultimately be a much greater regimentation of the individual consumer and a more definite channeling of productive facilities into war potential than at present if Canada is to achieve her greatest possible war effort.

L. B. Jack

Montreal,
16th May 1941.

TABLE OF EXCHANGE RATES

(Kindly supplied by The Canadian Bank of Commerce, Toronto)

	30th April 1941	*15th May 1941*
U.S. Dollars	10-11% P.	10-11% P.
Sterling	443-447	443-447
Australian Pounds	358½	358½
New Zealand Pounds	360	360
South African Pounds	443	443
British West Indian—Dollars	9270	9270
India—Rupees	3352	3352
Hongkong—Dollars	2692	2714
Straits Settlements—Dollars	5251	5251
*Finland—Finmarks	199	199
Sweden—Kronor	2637	2637
Switzerland—Francs	2566	2566

*Inland or blocked finmarks—Free finmarks 2.26c.

There are no quotations for Italy (lire) or for the following countries under the control of Germany: Belgium (belgas), Denmark (kroner), France (francs), Holland (florins), and Norway (kroner).

Note: The above quotations are expressed as follows: Pound currencies—Canadian cents per unit; Continental currencies and sundry British Empire—Canadian cents per 100 units.

NEW LEGISLATION RESPECTING TAXATION—DOMINION AND PROVINCIAL

(Continued from May issue)

Editor's Note: The information published under this heading indicates only in general terms the nature of recent legislation of the Provincial Governments respecting taxation. *For the Text of the legislation, readers should refer to the respective Acts.* A copy of a Dominion Statute can be obtained from the King's Printer, Ottawa, and of a Provincial Statute from the King's Printer of the Province concerned.

To provide information to chartered accountants who are called upon by their clients to prepare taxation returns in other provinces, The Dominion Association of Chartered Accountants some time ago sent to the reference library of each provincial Institute a complete set of income tax legislation passed by the various provincial legislatures, and is keeping this information up to date by sending copies of amendments to such legislation as soon as these amendments are available for distribution.

V. Alberta

The Income Tax Act Amendment Act, 1941—The principal sections of *The Income Tax Act* that were amended by the above Act are as follows:

(a) Section 4 is amended to add to the exemptions from taxation service pay and allowances of officers or men of the Naval, Military and Air Forces of Canada. The exemption granted to commissioned officers is confined to pay and allowances while they are on active service outside of Canada or in Canada and outside of Alberta.

(b) Section 5, subsection (1) is amended to provide for an exemption of $400 for each child brought from the United Kingdom owing to war conditions and maintained in Alberta by a taxpayer.

(c) Section 6, paragraph (g) had formerly disallowed all fees or salaries paid to a person as manager, director, etc., of a corporation where such person was non-resident unless a separate return was made therefor and income tax paid thereon at the personal rate. The new paragraph (g) changes this by applying the disallowance to expenses including salaries over and above what the Minister thinks is reasonable or normal for the business carried on by the taxpayer.

(d) Section 47 is amended by adding thereto a provision to validate the arrangement already made whereby taxpayers may pay their income tax in four equal consecutive monthly instalments without interest, the first one-quarter of such amount to be paid on or before 28th February. In the case of corporations whose fiscal year ends upon some other date than 31st December, the first quarter of such amount is payable within two months from the date upon which its fiscal year ends.

(e) Section 48 and section 53, subsection 3, which provided for penalties under certain conditions are repealed.

(f) The amendments to section 47 apply to all returns for and tax payable on income received in 1940; the amendments of sections 4, 5 and 6 are retroactive so as to apply to all income for the year 1940.

The Corporations Taxation Act Amendment Act, 1941—The only amendment made to *The Corporations Taxation Act* by this Act is the

striking out of the requirement as to the minimum tax in section 17a respecting companies operating natural gas processing plants.

The Corporations Temporary Additional Taxation Act and *The Banking Corporations Temporary Additional Taxation Act* — There were no amendments to these Acts to date in 1941.

VI. Prince Edward Island

The Personal Property and Special Companies Taxation Act — There were no amendments to this Act in 1941.

The Income Tax Act of Prince Edward Island—The amendments to this Act in 1941 have to do almost entirely with exemptions and deductions from income and are as follows:

(1) An exemption is granted of $200 for each child maintained by the taxpayer in Canada under a co-operative scheme sponsored by the governments of the United Kingdom and of Canada or any of the provinces of Canada for children brought from the United Kingdom under a government plan.

(2) Incomes not liable to taxation include the service pay and allowances of (a) warrant officers, non-commissioned officers and men of the Canadian Naval, Military and Air Forces while in the Canadian Active Service Forces, and (b) commissioned officers of the said Forces while on active service beyond Canada, or on active service in Canada, whose duties are of such a character as are required normally to be performed afloat or in aircraft.

(3) In the case of a corporation only such fees or salaries of directors shall be allowed as shall have been voted and authorized at an annual meeting held within two months after the commencement of the then current fiscal year in respect of which such fees or salaries are claimed as a deduction.

(4) That section of the Act which provides for the exemption of income arising from an annuity contract has now been made similar to the provisions of section 5, sub-section (k) of the *Income War Tax Act* (Dominion).

(5) Section 5 (m) of the Act provides as a deduction from the income of the taxpayer the tax payable under the *Income War Tax Act* in respect of the income of the year. The amendment provides that "this deduction shall not include any portion of Dominion income tax paid or payable in respect of any dividend excepted under the provisions of Section 4 (1) (n)," which section reads, "Dividends paid to an incorporated company by a company incorporated in Canada the profits of which have been taxed under the *Income War Tax Act* . . . ."

(6) The amount allowed as an exemption by way of charitable donations shall not be more than ten per centum of the net taxable income which has been actually paid within the taxation period to any approved patriotic organization.

(7) Provision is made for payment, without interest, of income taxes in instalments; the terms are the same as those provided for in the *Income War Tax Act*.

VII. Quebec

Quebec Income Tax Act—This Act was amended by chapter 23 of the Quebec Statutes of 1941 and was assented to 29th April. The principal amendments are as follows:

(1) The term "net income" has been re-defined as under:

" 'Net income' means income as defined by the *Income War Tax Act*

(Revised Statutes of Canada, 1927, chapter 97, and its amendments in force on the 1st of December 1940), after deducting the exemptions and deductions contemplated in the said act except those contemplated in paragraphs *c*, *d*, *e*, *ee*, *i*, *j*, and *n* of the first sub-section and in sub-sections 2 and 3 of section 5 thereof."

The exemptions and deductions referred to are those relating to married persons, etc., other persons, children, children from the United Kingdom, dependent relatives, donations and patriotic donations.

(2) The charging section (section 3) has been re-written and now reads as follows:

"1. In order to provide for the exigencies of the public service of the Province, every one of the persons contemplated under section 4 of this Act shall pay annually to His Majesty in the rights of the Province a tax equal to the percentage hereinafter fixed of the amount of the tax payable to His Majesty in the rights of the Dominion of Canada by any such person, upon the income during the preceding year, under the *Income War Tax Act* (Revised Statutes of Canada, 1927, chapter 97, and its amendments in force on the 1st of December 1940), except Part XV of the said act (National Defence Tax).

"2. Such percentage shall be as follows:

If the net income does not exceed $4,000, 4%;
If it exceeds $4,000 and not $6,000, 4½%;
If it exceeds $6,000 and not $8,000, 5½%;
If it exceeds $8,000 and not $12,000, 6%;
If it exceeds $12,000 and not $16,000, 6½%;
If it exceeds $16,000 and not $18,000, 7%;
If it exceeds $18,000 and not $25,000, 7½%;
If it exceeds $25,000 and not $30,000, 8½%;
If it exceeds $30,000 and not $35,000, 9%;
If it exceeds $35,000 and not $50,000, 10%;
If it exceeds $50,000 and not $60,000, 10½%;
If it exceeds $60,000 and not $80,000, 11%;
If it exceeds $80,000 and not $95,000, 11½%;
If it exceeds $95,000 .... 12%.

"3. The amount of the tax payable annually by any person under this section shall in no case exceed seven thousand dollars.

"4. The following persons shall be exempt from the tax contemplated by this section:

a. A married person having a net income of not more than two thousand dollars;

b. An unmarried person having a net income of not more than one thousand dollars."

(3) The Provincial Treasurer may alter the date on which the tax shall be payable and the date from which interest shall be chargeable in order to conform to similar provisions relating to the Dominion income tax.

(4) The amendments apply to the year 1940 and all fiscal periods ending therein and all subsequent periods.

The Corporation Tax Act—There were no amendments of this Act in 1941 (to date).

VIII. Saskatchewan

The Corporations Taxation Act — The principal amendments in 1941 relate to land companies, finance companies, insurance companies, loan companies and trust companies.

The Income Tax Act—The principal amendments in 1941 were as follows:

(1) The sections relating to personal corporations have been repealed. Such corporations will be dealt with in the same manner as other corporations.

(2) Dependent parents, grandparents, brothers or sisters need not be wholly dependent on the taxpayer to qualify for the exemption of $300. The other conditions under which this exemption is granted remain unchanged.

(3) An exemption of $300 is granted for each child brought from the United Kingdom on account of the present war and maintained in Canada by the taxpayer; provided such child is dependent on the taxpayer for support.

(4) Dominion income tax and the amount of the national defence tax paid by the taxpayer within the taxation period are allowed as a deduction from income. The deduction is limited to that proportion of the taxes that the income in Saskatchewan bears to the income taxable under the Dominion *Income War Tax Act.*

(5) Deduction of fees, salaries or bonuses to directors and officers are now in the discretion of the Commission. Formerly such items were deductible if separate returns were filed and tax paid thereon.

(6) The income of a person ordinarily resident in Saskatchewan is subject to taxation under the Act. The word "ordinarily" is new.

(7) Provision is made for reciprocal arrangements with other provinces to prevent double taxation.

(8) It would appear that arrangements are being made for administration of the Act by the Dominion authorities.

(9) The amendments apply to the year 1940 and to fiscal periods ending after 31st August 1940.

SOME NOTES ON THE UNITED KINGDOM INCOME TAX

By Bryan Pontifex, F.C.A.,
Knowle, Warwickshire, England

PROBABLY most Canadians have read cabled advices that British income tax has been increased from 8/6 (42½%) to 10/- (50%) in the £. It should however be borne in mind that this 10/- is what is called the "standard rate" which, owing to allowances in the initial amounts of income, is more than is actually borne by the taxpayer.

Personal allowances are now £80 for a single person and £140 for one married. The next £165 of taxable income is at the rate of 6/6, not 10/-, in the £. To come down to a concrete case—a married man with no children on £1,350 a year (all earned) will pay £520 a year income tax which is equivalent to about 38½%, or less than 8/- in the £, and

a married man with no children on the same income (but all investment income) will pay £589 (42½%) or only 8/6 in the £. (The "only" here is what Arthemus Ward, the American nineteenth century humourist, would have called a "goak"). Surtax starts at incomes over £2,000 a year and begins only at the rate of 2/- in the £.

The personal allowances were reduced from £100 and £170 to the above figures and the earned income allowances reduced from 1/6th to 1/10th, but a new feature was the mitigation of these by the enactment that the extra tax which any individual will pay by reason of the reduction in the personal allowance and the earned income allowance will be offset after the war by a credit which will then be given in his favour in the Post Office Savings Bank with a maximum of £65.

This deferred credit system is also to be applied to limited companies. The excess profits tax of 100% by which companies paid under Excess Profits Tax Acts the whole amount of their profits in a war year exceeding the profits in a basic peace year was found to be unjust in incidence, so 20% of this 100% is to be refunded after the war, but there's "a catch about it somewhere"—the 20% amount of the 20% excess profits tax repaid will "of course fall to be treated as taxable receipts and thus come under the charge for income tax."

The Chancellor of the Exchequer proposed another generosity—tax free voluntary loans to the government (of which the government received last year £28,000,000) need not be added back to the value of a deceased's estate for the purpose of computing estate duty.

"As a result the increases in the rate of income tax together with surtax will reach a maximum of 19/6 in the £ on the highest slices of income. In order to enjoy a tax free income of £5,000 a year ($22,350) it will be necessary to have a gross income of £66,000"—over a quarter of a million dollars a year.

GENERAL NOTES

Our Contributors This Month

JOHN HARVEY, who writes this month on some features of the accounting and financial control of a provincial government, was admitted a member of the Alberta Institute in 1914 and later became a member of the British Columbia Institute. In 1931 he joined the Department of Finance of the Province of British Columbia as supervising auditor in the income tax branch and is now Deputy Comptroller-General at Victoria.

C. A. ASHLEY, a member of the Ontario Institute, is professor of accounting in the Department of Political Economy of the University of Toronto; ALAN W. BELL and LAWRENCE B. JACK were contributors to our May issue; K. LEM. CARTER is manager in Toronto of the firm of McDonald, Currie & Co. of Montreal; and BRYAN PONTIFEX, now resident in England, is an honorary member and a former President of the Institute of Chartered Accountants of Ontario.

PROFESSOR R. G. H. SMAILS of the Department of Commerce and Administration of Queen's University is kindly contributing the Editorial Comments for the issues of the summer months.

Amendment of By-Law of Association

The last annual meeting of The Dominion Association of Chartered Accountants went on record as approving a rebate of annual fees to any constituent Institute of any member whose fees had been rebated by the Institute on account of serving in His Majesty's Forces, and it instructed the Council to take action to amend the Association's by-laws to that end.

The Executive Committee, at the direction of the Council, has given consideration to this matter. The following amendment will therefore be submitted at the 1941 annual meeting.

RESOLVED that the by-laws of The Dominion Association of Chartered Accountants be amended as follows:

By-law 6 is hereby amended by adding thereto the following paragraph:

The annual fee payable in respect of a member who is with any of His Majesty's Forces may be remitted; provided, however, that the Institute of which he is a member likewise remits the annual fee payable by him to such Institute.

The Unemployment Insurance Act

According to a statement made in the House of Commons on 15th May last by Honourable N. A. McLarty, Minister of Labour, the *Unemployment Insurance Act, 1940* (assented to 7th August 1940) "will be placed in operation and will start to function on 1st July next."

A copy of this Act was sent by the Secretary-Treasurer of the Dominion Association to the library of each of the Provincial Institutes on 13th September 1940. A reference to a later issue of the Act with explanatory notes and an index appeared at page 208 of our March issue.

Ruling Respecting National Defence Tax

We have received an inquiry about the necessity of paying the national defence tax in respect of dividends paid out of the surplus of family corporations.

We have inquired and have been informed by the Income Tax Division of the Department of National Revenue that "dividends paid out of tax-free surplus of family corporations on or before 31st December 1942 are not subject to general tax or national defence tax."

Auditing; Paying for Services Rendered

A few weeks ago one of our members in the Maritime provinces in a letter to us mentioned how important it was that the public know more about the auditing services for which municipal councils are paying.

It is not in the nature of the chartered accountant to go about boasting that he can perform a municipal audit much more efficiently than a "pick-up" auditor, but our correspondent felt that the public should have a better understanding of the functions of a professional auditor. He mentioned one town there that had decided now to engage a member of the profession and to pay for services rendered.

In its editorial section, a newspaper in Ontario on 8th May last dwelt on this very matter of engaging a qualified auditor for the town's accounts. "Many years ago," it stated, "it was not difficult to find among the average citizens of the community, a man able to fill this role to satisfaction, but in these days of intricate bookkeeping, and more detailed reports, it is essential that only a fully qualified man be appointed.

"It is preferable that a man with connections with an established firm of auditors be given the post. The reason for this suggestion is that he will then have the advice of men of long experience, and in that way will be able to give greater service to the municipality. Too many people misjudge the office of auditor. They appear to think that all that entails is a check-up of the books to see that entries agree with the vouchers, and that, if this is done, the books have been properly and adequately audited.

"That may have been satisfactory a few years ago, but it is not satisfactory now. An auditor should not only know what is on the books, but should be aware of the fundamentals of municipal financing and bookkeeping. He should have sufficient knowledge as to be able to advise the town of better ways to finance its operations, and of keeping its records in shape. Many towns smaller than . . . employ a firm of city auditors of long experience. Paradoxically a firm of chartered accountants is no more expensive than an ordinary citizen who might be good at figures. On the other hand while the work can be done more efficiently, the town can also benefit from the advice given by men who have spent their entire lives in this field, and who, because of their experience in municipal auditing may save the municipality many thousands of dollars. We have no particular person or firm to suggest to the council. There are many available, but we do suggest that they appoint an auditor who is able to give the town the proper service that an auditor should be able to give.

"There is just one other point that might be considered at this time, and that is the appointment of an auditor who would act not only for the town, but for the Hydro and Water Commissions, and even the Hospital. By correlating these municipal enterprises under the one auditor, we believe a saving could be effected, and more efficiency established."

Exchequer Court in Maritimes

According to an announcement in *The Canada Gazette*, 3rd May, general sittings of The Exchequer Court of Canada for the trial of cases will be held in the following cities in the Maritime Provinces, provided that a case is entered for trial at the office of the Registrar of the Court at Ottawa on or before 9th June 1941.

Saint John, N.B., 20th June, 10.30 a.m. city time
Halifax, N.S., 23rd June, 10.30 a.m. city time
Sydney, N.S., 25th June, 10.30 a.m. city time
Charlottetown, P.E.I., 30th June, 10.30 a.m. city time

Machinery and Machine Tools

The Minister of Munitions and Supply has among other duties that of organizing the sources of supply of munitions of war and the agencies available for the supply of the same. As it was deemed necessary to conserve and coördinate the supply of machinery and machine tools required for the manufacture of munitions and to regulate the sale and distribution of the same, the government by order in council 22nd August last appointed a Machine Tools Controller and issued regulations for his department.

In a recent communication from the Controller, Thomas Arnold, 1020 Dominion Square Building, Montreal, he has asked us to refer to this in the interests of the Department of Munitions and Supply inasmuch as there have been instances during the past year of accounting firms in liquidating estates and authorizing auction sales of machinery and machine tools not being aware of the governmental requirements in respect thereto.

"Come Wind, Come Weather"

Greeting one from almost every bookstore is Daphne Du Maurier's little book "Come Wind, Come Weather" (published in Canada by the *Ryerson Press*, Toronto). Appearing first in Great Britain in August 1940, it has already had a sale of over half a million copies there, the greatest demand coming from the bombed districts of London. It consists of ten brief true stories of some ordinary people

who have given their best to England and their country, and have done deeds of gallantry in their respective spheres. "Here is a record of fortitude, quiet courage and self-sacrificing fellowship," states *The Gazette* (Montreal); "it may be taken as an answer to that question 'what are we fighting for?' It is for justice, the right and a happier world."

About Dependents

The following limerick, prepared by an acquaintance of one of our members, was inspired by a recent ruling of the Income Tax Department in regard to dependents, and has been sent in to us:

Dependency—often exiguous,
With relationships sometimes ambiguous—
(To exempt) must obtain
In a British domain,
Or country (to ours) contiguous.

LEGAL DECISIONS

[Editor's Note: The following are brief summaries of recent decisions of the Canadian Courts as taken, by the kind permission of the Canada Law Book Company, from the *Dominion Law Reports*. In each case reference is made to the volume of the *Reports* where the full judgment may be found. It should be kept in mind that the decisions given may not in every case be final.]

Auditors—Statutory audit

(Guardian Insurance Co. v. *Sharp et al)*

Supreme Court of Canada

Auditors engaged to make the statutory audit of a company's books required by s. 120 of *The Companies Act, 1934* (Can.), c. 33, as distinct from a special investigation under a special contract, are entitled, in the absence of anything calculated to arouse suspicion, to presume the honesty of the company's employees and the efficacy of its internal control.

Held, inasmuch as a company's duplicate bank deposit slips are of no value for the purposes of a statutory audit, the auditors are not negligent in failing to examine them where there is nothing to arouse suspicion, although such an examination would have disclosed that the company's

cashier had been defrauding the company over a period of years.—[1941] 2 D.L.R. 417.

(*Note:* The text of the judgment of Mr. Justice Davis in this case was published in the February 1941 issue of THE CANADIAN CHARTERED ACCOUNTANT. The judgment of Rinfret and Taschereau JJ. delivered by Taschereau, J. and the judgment of Crocket, Davis and Hudson, JJ. delivered by Davis, J. appear in *Canada Law Reports*, Part II-1941).

Companies—Close corporation—Restrictions on transfer of shares—Invalidity of

(re Emerson et al)

New Brunswick Supreme Court

Section 74(1) of the *Companies Act*, R.S.N.B. 1927, c. 88, which empowers a company by by-law to constitute itself a close corporation and to provide that its shares "shall not be transferable to any person not being a shareholder" except with the directors' consent "or upon such other terms or conditions as may be provided by such by-law," does not authorize by-laws prohibiting a shareholder from transferring his shares unless with the directors' authority or from selling, transferring, bequeathing or otherwise disposing of his shares except subject to the right of pre-emption by the remaining shareholders at par value.—[1941] 2 D.L.R. 232.

Judgments re Income War Tax Act

Editor's Note: The judgments of the Exchequer Court of Canada in the *Montreal Light, Heat & Power Consolidated* case and *The Montreal Coke and Manufacturing Company* case are published at pages 21 to 32 of the *Canada Law Reports:* Part II-1941. Summaries of these judgments were published in the February 1941 issue of THE CANADIAN CHARTERED ACCOUNTANT.

Mining—Oil production—Found "in paying quantities"

(Stevenson v. Westgate)

Ontario Supreme Court

A lessee of oil lands "for one year and such longer period as oil or gas is found in paying quantities" expended over $4,000 during the first year, principally in capital expenses,

the operating cost being $229, while the oil produced was worth $539. *Held,* oil was produced "in paying quantities," the test being by reference to the cost of operation (including the lessor's share of the production) and not to the capital cost; the lease therefore continued in force, and the lessor having ousted the lessee from the land the latter was entitled to specific performance of the lease and damages.—[1941] 2 D.L.R. 471.

Partnership dealings with mining properties—Action for accounting

(Winsby v. *Tait)*

Supreme Court of Canada

Section 12 of the *Mineral Act,* R.S.B.C. 1936, c. 181, which provides that no person shall be recognized as having any right or interest in or to any mining property unless he has a free miner's certificate, does not prevent a member of a partnership from demanding an accounting of his share of the profits made out of the partnership's dealings in mining properties although he is not the holder of such a certificate. *Per* Crocket and Davis JJ.: The plaintiff not having alleged or claimed dissolution of the partnership and there being no special circumstances to take the case out of the general rule that an account of partnership dealings will not be ordered unless the plaintiff also claims dissolution, the partnership must be taken to have been dissolved as of the date of the issue of the writ.—[1941] 2 D.L.R. 81.

Promissory note—Given as collateral security—Not promissory note

(Shaw v. *Agnew)*

Ontario Court of Appeal

An instrument in the form of a promissory note containing the words "This note is to be held as security for cheques given" is not a promissory note, the effect of the words being that it is given as collateral security and thus not payable unconditionally. Where such words are added by an accommodation maker, their deletion without his

knowledge by the principal maker before delivery to the payee does not make the instrument a promissory note so as to affect the liability of the accommodation maker.—[1941] 2 D.L.R. 587.

Promissory note—Partial failure of consideration—Endorser deriving title from holder in due course—Right to recover

(Scott v. *Ashley Colter Ltd.)*

New Brunswick Supreme Court

Partial failure of consideration for a promissory note is no defence to an action by an endorser with knowledge thereof, who derived title to the note, when overdue, from a holder in due course; and this whether or not he gave value for the note.—[1941] 2 D.L.R. 192.

Succession duty—Estimating value of shares—Restrictions on transfer of

(re Emerson et al)

New Brunswick Supreme Court

Under s. 5 of the *Succession Duty Act,* 1938 (N.B.), c. 12, the value of company shares passing on death must be estimated without regard to restrictions upon the transfer of such shares imposed by the company's by-laws, as that the remaining shareholders have a right of pre-emption at par value.—[1941] 2 D.L.R. 232.

Taxes—Income accumulating in trust for benefit of unascertained persons—"Charitable institution"

(re Cosman Estate)

Exchequer Court of Canada

A testator by his will directed the accumulation of certain funds in the hands of trustees in Nova Scotia until the happening of a certain event whereupon half of the fund should be paid to trustees in Ireland and half retained by the Nova Scotia trustees; the income from half of each

resulting fund should then be used for the benefit of the poor and needy of Nova Scotia and Ireland respectively, whilst the remaining half of each resulting fund should be allowed to accumulate for a long period and then used to establish homes for the needy in Nova Scotia and Ireland respectively, under the direction of a Church dignitary in each place and of others appointed by such dignitaries. Held, the income of the whole of the fund while still accumulating in the hands of the Nova Scotia trustees before the happening of the specified event is "income accumulating in trust for the benefit of unascertained individuals," viz. the poor and needy in Nova Scotia and Ireland, and is therefore taxable under s. 11(2) of the *Income War Tax Act,* R.S.C. 1927, c. 97. The Nova Scotia trustees do not constitute a "charitable institution" within the meaning of s. 4(e) so as to render the income exempt from taxation.—[1941] 2 D.L.R. 218.

OBITUARY

The Late James Douglas Payne

The Institute of Chartered Accountants of Ontario regrets to announce the death at Toronto on 25th April 1941 of James Douglas Payne, a younger member of the Institute.

The late Mr. Payne was elected to membership in the Institute on 27th January 1933 while in the employ of Messrs. Clarkson, Gordon, Dilworth & Nash. On 1st April 1937 he took a position with Ventures, Limited, with which organization he was associated at the time of his death.

To his family the Council and members of the Institute offer sincere sympathy.

BOOK REVIEWS

BUDGETARY ADMINISTRATION

In the United States Department of Agriculture

By Verne B. Lewis

(Published by *Public Administration Service*, Chicago, 1941, paper, 64 pages, price, seventy-five cents).

This monograph published as Appendix A of "Public Administration and the United States Department of Agriculture" is a descriptive and analytical account of budgetary administration and control in one of the largest agencies of government in the world. The Department's staff comprised about 80,000 regular employees and in addition a large corps of temporary and seasonal workers. Several of its bureaus, such as the A.A.A., Forest Service, Soil Conservation Service and F.S.A. had budgets for running expenses exceeding $10,000,000 and had staffs of several thousand persons. The Department's total of about $1,480,000,000 estimated obligations for the fiscal year 1940 constituted about one-seventh of the federal budget. Not more than 15 per cent of the funds appropriated to the Department of Agriculture were for financing the Department itself. Program outlays including conservation and parity payments to farmers, expenditures for disposal of surplus commodities, rural rehabilitation loans and grants, farm tenancy loans, rural electrification loans, grants-in-aid to states for extension work and agricultural research accounted for nearly $1,200,000,000 or over four-fifths of the Department's expenditures. The character of these outlays involved large questions of policies and programs with a direct bearing upon the pocket-books of millions of citizens, the rural groups particularly.

The significance, structure and bases of itemizing the Appropriation Act are discussed and the organization for budgetary administration and the formulation of the budget are described. There are four principal steps in the preparation of the annual estimates. First, the bureaus prepare the bureau estimates, second, the departmental officials review the bureau estimates and prepare the departmental estimates; third, the bureau of the budget and the President review the departmental estimates and determine the President's estimates; and fourth the Congress consider the President's proposals and enact the appropriation bill. About fourteen months elapse from the first steps in budget making in the bureau until final legislative action. In Flow Charts on pages 16-18 the rather complex procedure of preparation and review can be followed from the time the budget office of the department calls for bureau estimates until the senate takes final action on the bill. In 1940 the position of the budget officers within the bureaus was in an evolutionary condition, but it would seem that there is a higher degree of specialization than we have yet in Ottawa. An important part of the preparation is the justification of each proposed expenditure.

Upon submission to the congress a standing subcommittee of the committee on appropriation in each house considers the estimates of the department. The secretary who is a member of the executive and not a member of the congress, the budget officer and the bureau officials appear before the house subcommittee to explain and justify the proposals. The bureau officials present the main body of the testimony for congressmen want to deal directly with those who are charged with the administration and are posted on the details. Ad-

ministrators and legislators seldom speak the same language and it is the budget officer who bridges the gap by interpreting technical programs to congressmen. The subcommittee uses the opportunity to question the administrators both on the way in which the contemplated funds are to be used and on the performance of activities financed by appropriations of previous years. Frequently congressmen express opinions that have great weight on the departmental use of appropriations. This close contact between legislators and administrators is also missing at Ottawa, where the minister as a member of the cabinet and of the house of commons presents the estimates to the whole house.

The author then discusses the execution of the budget and particularly the various controls. Finally there is a section devoted to the need for improved budgetary practices, one of which is the suggestion that because of the burden of budget work appropriations be put on a biennial rather than an annual basis.

The booklet is published under the auspices of the Committee on Public Administration of the Social Science Research Council. In this connection it is interesting to note that a Canadian Social Science Research Council has very recently been organized.

Ottawa, W. F. CHOWN.
8th May 1941.

C.P.A. REVIEW: AUDITING AND THEORY

By Louis Marder, LL.B., C.P.A.

(Published by *Concise Text Press*, 136 Liberty Street, New York City, 1941, cloth, 440 pages, price $3.50 U.S. funds)

This publication of examination questions and answers is, according to the author, written for candidates in accountancy and auditing examinations who wish to face examinations with greater confidence. One of the shortcomings of a candidate is to make his answers too long, including therein irrelevant matters and finishing with remarks that have no definite bearing on the subject to be discussed. This book is designed to illustrate brevity and conciseness in answers—features which are looked for by the examiner, and if acquired by the examinee are a valuable time-saver to the candidate.

Mr. Marder's review is based on actual questions from past examination papers of the several states throughout the United States and cover a great variety of subjects including amortization, auditing, balance sheet, consolidations, depreciation, dividends, inventories, municipalities, partnerships, surplus and utilities.

Toronto,
16th May 1941.

STUDENTS' DEPARTMENT

R. G. H. SMAILS, C.A., Editor

NOTES AND COMMENT

At the time this issue of the magazine appears some of our readers will be presenting themselves for the mid-year final examination of the several provincial institutes which is being held in order to quicken the flow of qualified accountants into war service of one kind and another. We hope that all of those who have prepared diligently for this test will be successful in it.

An accounting examination at any time makes heavy demands upon the nervous strength of the candidate and at the present time the candidate throughout his course of preparation has been continuously subject to the abnormal nervous and emotional stress associated with the war. It is therefore especially important that he should guard deliberately and scientifically against "blowing up" in the examination hall and presenting the examiner with a mass of incoherent words and disordered figures for which, with the best will in the world, it is impossible for the examiner to give any credit. There is much advice that can be given in this connection but we shall confine ourselves to two suggestions. One is to do no studying whatever during the period of the examination but to devote every available hour to either outdoor exercise, detective fiction or sleep. The other is to start work in the examination room on a *minor* question or problem, that is to say one that calls for a relatively short answer and carries proportionately few marks. An examinee is not on his mental toes at the outset; his brain has to warm up before it can be put into high gear and meanwhile he will work indifferently and inaccurately. Suppose he makes the mistake of starting on a problem which he feels confidence in tackling but which involves the building of a large structure. At the end of the allotted time for this problem and as a result of some slight error in the early stages he finds that his balance sheet (or whatever it may be) does not balance. The shock to his confidence from the feeling that he has accomplished nothing is likely to be critical; and he will too often spend the remainder of his time in futile

endeavour to discover what is wrong with his solution to the first problem or in hysterical and quite ineffectual grappling with the rest of the paper. The examinee who does make this error in the choice of his first problem should, on discovery of his error, muster all his will power to tear himself immediately away from that faulty solution (for which the examiner will give all possible credit) and to remind himself that he does not have to complete the whole paper entirely correctly in order to get a mark of 50, 60 or even 75 per cent on that paper.

* * *

We were recently surprised, on reading an article on accounting for stock-dividends, to find that the author did not consider that use of the term "dividend" implied any transfer from surplus to capital and that accordingly he regarded stock-split and stock-dividend as synonymous. We ourselves do not think that a stock dividend is a dividend in any real sense of the term since it does not involve any distribution of assets amongst shareholders or cause any diminution in net worth, but this is not to admit that a stock dividend is the same thing as a stock split. Indeed we contend vigorously that when management uses the term stock-dividend it is committing the company to a significant reduction in the amount of the distributable equity and an equal increase in the amount of the non-distributable or capital equity. If this is not the intention then management should refer to the operation as a stock split—a perfectly unequivocal term whose meaning is known to all investors.

The history of stock dividends in fact suggests that they might to advantage be prohibited and that any formal capitalization of surplus might well require the approval of the shareholders in general meeting.

PROBLEMS AND SOLUTIONS

Solutions presented in this section are prepared by practising members of the several provincial Institutes and represent the personal views and opinions of those members. They are designed not as models for submission to the examiner but rather as such discussion and explanation of the problem as will make its study of benefit to the student. Discussion of solutions presented is cordially invited.

PROBLEM I

THE PROVINCIAL INSTITUTES OF CHARTERED ACCOUNTANTS

FINAL EXAMINATION, DECEMBER 1940

Accounting II, Question 1 (35 marks)

The Acadia Accessories Manufacturing Co., Limited, is a subsidiary company, manufacturing two articles which are sold to the parent company, at a fixed price each of: Article No. 1, $85.00; Article No. 2, $140.00.

Standard costs are used throughout, and all inventories, and cost of sales, are stated at standard cost. Overhead rates are established on the basis of productive labour hours.

The profit and loss account of the company for the year ended 30th September 1940, is as follows:

Sales		$422,000.00
Cost of sales:		
At standard cost	$353,420.00	
Net variations	1,582.50	
		355,002.50
		66,997.50
General and administrative expenses	30,000.00	
Bond interest	15,000.00	
		45,000.00
		21,997.50
Provision for income taxes		4,000.00
Net Profit		$ 17,997.50

The balance sheet as at 30th September 1940 was as follows:

ASSETS

Cash in bank		$ 13,160.00
Accounts receivable (parent company)		27,416.00
Inventories:		
Supplies (at cost)	$ 1,200.00	
Raw material (at standard)	9,200.00	
Work-in-process (at standard)	10,990.50	
Finished goods (at standard)	10,918.00	
		32,308.50
Fixed assets, less depreciation		480,000.00
		$552,884.50

LIABILITIES

Accounts payable	$ 9,200.00	
Accrued bond interest	3,750.00	
Provision for income taxes (payable 31st January 1941)	4,000.00	
		$ 16,950.00
Bonds: 5%, interest payable semi-annually (30th June and 31st December)		300,000.00
Capital stock		200,000.00
Surplus		35,934.50
		$552,884.50

Following are details in connection with operations for the year:

Opening inventories:

Raw materials (at standard)	$ 8,160.00
Work-in-process	nil
Finished goods	12,541.00
(110 Article No. 1; 40 Article No. 2)	

Production schedule for year:

	Dept. 1	Dept. 2	Dept. 3
Article No. 1:			
Put into production	2,100	2,050	2,050
Finished	2,050	2,050	2,010
In process at end of year	50	....	40
Article No. 2:			
Put in production	1,860	1,860	1,830
Finished	1,860	1,830	1,780
In process at end of year	....	30	50

Sales:
2,000 of Article No. 1
1,800 of Article No. 2

All material goes in at the beginning of the manufacturing process in Dept. 1. Work-in-process may be considered as averaging half-finished in the department in which it is at the close of the year.

Material:

Total purchases for year (at cost)	$89,795.00
Issued (at standard):	
Article No. 1.	29,400.00
Article No. 2	58,590.00

Analysis of productive wages:

	Dept. 1	Dept. 2	Dept. 3
Article No. 1:			
Wages at standard rates	$17,430.00	$28,700.00	$16,240.00
Productive labour hours	14,525	20,500	16,240
Article No. 2:			
Wages at standard rates	$17,856.00	$45,202.50	$19,855.00
Productive labour hours	14,880	32,287½	19,855

Total wages (productive) paid—$145,551.00.

Details of factory overhead:

Fixed:			
Depreciation	$ 4,116.00	$18,400.00	$13,700.00
Superintendence	5,700.00	12,000.00	7,500.00
Taxes	480.00	720.00	600.00
Heating	1,210.00	1,860.00	1,420.00
Insurance	1,100.00	3,400.00	2,200.00
	$12,606.00	$36,380.00	$25,420.00
Variable:			
Indirect wages	$ 4,200.00	$ 6,655.00	$ 5,170.00
Power	2,870.00	8,620.00	6,200.00
Supplies	5,710.00	7,840.00	1,840.00
Repairs and maintenance	1,430.00	3,715.00	1,408.00
	$14,210.00	$26,830.00	$14,618.00
Total	$26,816.00	$63,210.00	$40,038.00
Absorbed (at standard rates)	$26,464.50	$63,345.00	$39,704.50

REQUIRED:

(a) Trading and profit and loss account showing separately sales and costs of the two articles, with unit costs. (divide expenses, etc., on the basis of sales.)

(b) Detail of inventories of work-in-process and finished goods.

(c) Detail of variations charged in the profit and loss account.

SOLUTION

Determination of standard costs:

Material	Amount	Units	Per Unit
Article No. 1	$29,400.00	2,100	$14.00
Article No. 2	58,590.00	1,860	31.50

Labour	Dept. 1	Dept. 2	Dept. 3
Article No. 1—equivalent of finished units	2,075	2,050	2,030
Labour cost (standard)	$17,430.00	$28,700.00	$16,240.00
Per unit	$8.40	$14.00	$8.00
Article No. 2—equivalent of finished units	1,860	1,845	1,805
Labour cost (standard)	$17,856.00	$45,202.50	$19,855.00
Per unit	$9.60	$24.50	$11.00

Overhead			
Productive labour hours	29,405	52,787½	36,095
Overhead (standard)	$26,464.50	$63,345.00	$39,704.50
Rate per Hour	$ .90	$1.20	$1.10

Productive labour hours per article:

Article No. 1			
Equivalent of finished units ..	2,075	2,050	2,030
Productive labour hours	14,525	20,500	16,240
Hours per unit	7	10	8
At rates as above	$6.30	$12.00	$8.80
Article No. 2			
Equivalent of finished units ..	1,860	1,845	1,805
Productive labour hours	14,880	32,287½	19,855
Hours per unit	8	17½	11
At rates as above	$7.20	$21.00	$12.10

Summary:	Article No. 1	Article No. 2
Dept. 1		
Material	$14.00	$31.50
Labour	8.40	9.60
Overhead	6.30	7.20
Dept. 2		
Labour	14.00	24.50
Overhead	12.00	21.00
Dept. 3		
Labour	8.00	11.00
Overhead	8.80	12.10
	$71.50	$116.90

(a)

TRADING AND PROFIT AND LOSS ACCOUNT FOR YEAR ENDED 30th SEPTEMBER 1940

	Article 1		Article 2		Total
Units	2000		1800		
	Amount	Per Unit	Amount	Per Unit	
Sales	$170,000.00	$85.00	$252,000.00	$140.00	$422,000.00
Cost of Sales:					
Standard ...	143,000.00	71.50	210,420.00	116.90	353,420.00
Variations ..	637.50	.319	945.00	.525	1,582.50
	143,637.50	71.819	211,365.00	117.425	355,002.50
Gross Profit ..	26,362.50	13.181	40,635.00	22.575	66,997.50

General and administrative expense	12,085.30	6.043	17,914.70	9.953	30,000.00
Bond interest .	6,042.65	3.021	8,957.35	4.976	15,000.00
	18,127.95	9.064	26,872.05	14,929	45,000.00
	8,234.55	4.117	13,762.95	7.646	21,997.50
Income tax ..	1,611.00	.806	2,389.00	1.326	4,000.00
Net Profit ....$	6,623.55	$3.31	$11,373.95	$6.32	$17,997.50

(b)

Inventories:

Work-in-process:

Article 1

Dept. 1	Material	$ 14.00	
	½ Labour and overhead	7.35	
	50 @...........	$ 21.35	$1,067.50
Dept. 3	Total cost Dept. 1	28.70	
	Total cost Dept. 2	26.00	
	½ Labour and overhead, Dept. 3	8.40	
	40 @...........	$ 63.10	2,524.00

Article 2

Dept. 2	Total cost Dept. 1	48.30	
	½ Labour and overhead, Dept. 2	22.75	
	30 @...........	$ 71.05	2,131.50
Dept. 3	Total cost Dept. 1	48.30	
	Total cost Dept. 2	45.50	
	½ Labour and overhead, Dept. 3	11.55	
	50 @...........	$105.35	5,267.50
			$10,990.50

Finished goods:

Article 1

Opening inventory	110			
Production	2010			
	2120			
Sold	2000			
Closing inventory	120	@	$71.50	$8,580.00

Article 2

Opening inventory	40		
Production	1780		
	1820		
Sold	1800		
Closing inventory	20	@ $116.90	2,338.00
			$10,918.00

(c) **Detail of Variations:**

			Variation (Dr.)
Material			
Opening inventory		$ 8,160.00	
Purchases		89,795.00	
		97,955.00	
Closing inventory		9,200.00	
		88,755.00	
Issues at standard		87,990.00	$ 765.00
Labour			
Total paid		145,551.00	
Absorbed:			
Article No. 1	$62,370.		
Article No. 2	82,913.50		
		145,283.50	267.50
Overhead:			
Actual		130,064.00	
Absorbed		129,514.00	550.00
			$1,582.50

PROBLEM II

THE PROVINCIAL INSTITUTES OF CHARTERED ACCOUNTANTS

FINAL EXAMINATION, DECEMBER 1940

Accounting II. Question 2 (25 marks)

The parent company of the Acadia Accessories Manufacturing Co., Limited, (see Problem I) supplies any temporary additional working capital required by its subsidiaries, and, for budgetting purposes, the subsidiary companies must submit estimated cash statements, by months, for the succeeding six months, showing these estimated requirements, and probable repayments. Advances are made in multiples of $5,000 and bear interest, payable monthly, at 6%. Any such advances may be considered as made at the beginning of the month, with interest payable on the last day of the same month; and repayments as made on the last day of the month.

The parent company pays for all goods purchased from the subsidiary in the succeeding month, without deduction of discount. The month-end cash balance should not be less than $10,000.00 and need not be more than $15,000.00.

Materials are purchased on credit and are paid for during the month following purchase. Raw material inventory at the end of each month should be approximately the requirements of the succeeding month.

Wages, administrative expense, and all items of overhead, except depreciation, may be considered as being payable in cash in equal instalments each month.

Work-in-process and supplies inventories are not expected to vary appreciably from month to month.

During the early months of the year stocks of finished goods are accumulated, shipments only being made as the goods are required by the parent company.

The estimated production and shipments for the six months are as follows:

Article No. 1—Production, 215 units per month

Article No. 2—Production, 200 units per month

Shipments:	Article No. 1	Article No. 2
October	120	160
November	130	150
December	160	100
January	290	300
February	270	240
March	320	210

There is no anticipated change in material or labour costs, but, owing to increased production over the previous year, variable factory overhead costs are estimated to increase by approximately two-thirds of the increased production, based on increase of productive labour hours. It may be assumed that production was uniform by months throughout the past year:

REQUIRED:

The estimated cash budget for the six months ending 31st March 1941, so as to show estimated requirements of working capital and estimated dates of repayment.

SOLUTION

CASH RECEIPTS:

Proceeds of sales	Article 1	Article 2	Total	Receipts
Account receivable, Sept.			$27,416	
1st month	$10,200	$22,400	32,600	$27,416
2nd month	11,050	21,000	32,050	32,600
3rd month	13,600	14,000	27,600	32,050
4th month	24,650	42,000	66,650	27,600
5th month	22,950	33,600	56,550	66,650
6th month	26,600	29,400	56,000	56,550

Cash Payments:

Material

Required for production (per month)

Article No. 1—215 @ $14.00	$ 3,010
Article No. 2—200 @ $31.50	6,300
	$9,310

	Purchases	Closing Inventory	Used in Production	Payments
Opening inventory	$ 9,200			
1st month	9,420	$ 9,310	$ 9,310	$ 9,200
2nd month	9,310	9,310	9,310	9,420
3rd to 6th months	9,310	9,310	9,310	9,310

Productive labour (per month)

Article No. 1—215 @ $30.40	$ 6,536
Article No. 2—200 @ $45.10	9,020
	$15,556

Administrative expense (per month)	$ 2,500

Overhead—fixed	Dept. 1	Dept. 2	Dept.3	Total
Year to 30th September 1940	$12,606	$36,380	$25,420	
Less Depreciation	4,116	18,400	13,700	
	$ 8,490	$17,980	$11,720	$38,190
Per month—1/12th of $38,190				$ 3,182

Overhead—variable

Year to 30th September 1940	$14,210	$26,830	$14,618	55,658
Estimated increase (see below)	—	19%		10,575
				66,233
Per month—1/12th of $66,233				$ 5,520

Estimate of increase in variable overhead:

Productive labour hours

Year to 30th September 1940	14,525	20,500	16,240	
	14,880	32,287	19,855	
	29,405	52,787	36,095	
6 months' equivalent	14,702	26,393	18,047	59,142
6 months to 31 March 1941				
1290 x 7 : 10 : 8	9,030	12,900	10,320	
1200 x 8 : 17½ : 11	9,600	21,000	13,200	
	$18,630	$33,900	$23,520	76,050

Increase	16,908
Percentage of increase	28.6
Two-thirds	19
Bond interest—December	$ 7,500
Income tax—January	$ 4,000

ESTIMATED CASH RECEIPTS AND DISBURSEMENTS

Receipts	October	November	December	January	February	March
Balance forward	$13,160	$14,568	$10,940	$14,297	$11,654	$12,061
Accounts receivable	27,416	32,600	32,050	27,600	66,650	56,550
Loans	10,000		15,000	10,000		
	$50,576	$47,168	$57,990	$51,897	$78,304	$68,611
Disbursements						
Materials	$ 9,200	$ 9,420	$ 9,310	$ 9,310	$ 9,310	$ 9,310
Productive wages	15,556	15,556	15,556	15,556	15,556	15,556
Overhead—fixed	3,182	3,182	3,182	3,182	3,182	3,182
Overhead—variable	5,520	5,520	5,520	5,520	5,520	5,520
Administrative expense	2,500	2,500	2,500	2,500	2,500	2,500
Bond interest			7,500			
Income taxes				4,000		
Interest on loans	50	50	125	175	175	25
Loans repaid					30,000	5,000
	$36,008	$36,228	$43,693	$40,243	$66,243	$41,093
Balance—end of month	$14,568	$10,940	$14,297	$11,654	$12,061	$27,518